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Politics this week



Pakistan's difficult relationship with the United States became more complicated after the American mission that killed Osama bin Laden in Abbottabad. Pakistanis fumed about America's incursion into their territory and its insinuation that they knew where bin Laden had been hiding. Both countries were at odds over who would question his widows. The CIA's station chief in Pakistan had his identity blown, which some reckoned to be a retaliation. See article

Japan's prime minister, Naoto Kan, demanded a temporary shutdown of the power plant at Hamaoka, an ageing facility near a tectonic fault line. He also suggested that a pre-tsunami plan to increase the country's reliance on nuclear power should be scrapped and greater emphasis placed on renewable energy. Japan's nuclear industry was shocked. See article

The date of **Thailand's** general election was set for July 3rd. A candidate for the party of Thaksin Shinawatra, an exiled icon of the red-shirt protest movement, was shot and wounded, boding ill for the campaign season ahead.

Singapore's ruling People's Action Party was re-elected with a majority of 81 to 6, which the opposition regarded as a breakthrough; the PAP won only 60% of the vote, much less than in 2006 and 2001. Lee Hsien Loong, the prime minister and son of the city-state's first prime minister, broke with tradition and acknowledged mistakes, promising to do better in future. See article

Samoa said it wanted to move its clocks 24 hours forward, in effect changing the Pacific's already zigzagging international dateline. The switch would bring the island chain onto the same business day as Australia, New Zealand and its trading partners in Asia, reversing a decision it made 119 years ago to align its time with American trading hours.

King Rafael

Ecuador voted on a package of ten constitutional amendments, many of which would expand the power of Rafael Correa, the president. Although Mr Correa declared victory based on exit polling, the official count has been slow, and two key amendments are on a knife-edge. See article

A **Guatemalan** court acquitted Alfonso Portillo, a former president, of embezzlement charges. The UN-sponsored International Commission Against Impunity in Guatemala denounced the decision. The United States and France have requested Mr Portillo's extradition.

A cold spring in Damascus

Syrian government emissaries held tentative talks with some veteran dissidents, while the security forces killed scores of protesters and fired artillery at restive sections of Homs, Syria's third-most-populous city. In Aleppo, Syria's second city, security forces broke up the biggest protest so far. See article

Libyan rebels strengthened their grip on Misrata, the city closest to the capital, Tripoli, which is still in rebel hands. They were reported to have captured the airport and strengthened the naval lifeline between Misrata and Benghazi, the rebels' capital in the east.

Twenty years after taking power, **Chad's** Idriss Deby was re-elected for a fourth term as president, apparently with 89% of votes cast.

A report by American scientists estimated that, on average, 48 women and girls are raped every hour in the **Democratic Republic of Congo**, a much higher rate than that suggested by UN figures.

After worldwide protests, the **Ugandan** parliament suspended a bill that called for the death penalty for homosexuals.

To AV and to AV not



Britain's Liberal Democrats, the junior party in the coalition government, suffered a double electoral whammy. In local elections they lost hundreds of council seats to the opposition Labour Party. And a referendum on switching to the alternative-vote system for parliamentary elections, supported by the Lib Dems but vociferously opposed by the Conservatives, the coalition's senior party, was defeated by 68% to 32%. Nick Clegg, the Lib Dems' leader, pledged to fight for "muscular liberalism"; the same day he lost a vote in the House of Lords to introduce elected police commissioners, a key Lib Dem policy. See article

The Scottish National Party, which advocates **Scotland's** secession from the United Kingdom, won a surprising majority of seats in elections to the Scottish Parliament. Alex Salmond, the party's leader, said a referendum on Scottish independence would be held in the second half of the parliamentary term. See article

Mario Draghi, head of Italy's central bank, came a step closer to succeeding Jean-Claude Trichet as president of the European Central Bank when Angela Merkel, the German chancellor, told a newspaper that she "could support" his candidacy. Mr Draghi has already secured the support of France.

Both the international envoy to **Bosnia** and the International Crisis Group, a think-tank, said Bosnia was facing its worst crisis since the end of the fighting in 1995. The immediate danger is a threat by the leader of Bosnia's Serbian part to hold a referendum on whether to accept the judicial authority of the federal state. Bosnia has been without a central government since elections seven months ago.

An earthquake of magnitude 5.1 shook **Spain's** southern Murcia region, killing at least ten people, the worst tremor in the country for 50 years.

It's a tough job...

There were some twitches of life in the **Republican race** for president. Newt Gingrich, a former speaker of the House who famously shut down the government in 1995, declared his candidacy. And Mitt Romney prepared to outline his plans for health care. The putative Republican front-runner is often credited with implementing an early version of Obamacare when he was governor of Massachusetts; he has been trying to distance himself from the policy ever since. See article

Barack Obama went to El Paso to vaunt his administration's efforts on **border security** and to chastise Republicans for not doing more to reform immigration laws, an early play for the Hispanic vote ahead of next year's election. See article



The **Mississippi River** reached its highest level in some places for 70 years, causing severe flooding in Tennessee and elsewhere. The impoverished Mississippi Delta and Louisiana prepared for the worst.

Business this week

Raj Rajaratnam was found guilty of securities fraud in the biggest insider-trading case in a generation. Mr Rajaratnam used to run Galleon, one of the world's largest hedge funds, until his arrest in 2009 on charges of operating a network of executives, bankers and traders through which he obtained illegal tips. The scandal has reached the boardroom of Goldman Sachs, where a former board member denies charges by the Securities and Exchange Commission that he provided information to Mr Rajaratnam. See article

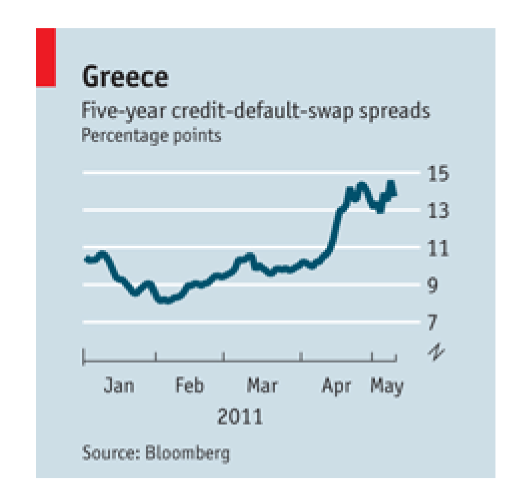
Skype's the limit

Microsoft's agreement to buy **Skype** raised a few eyebrows. At $8.5 billion the deal is Microsoft's biggest acquisition to date, and provides a $4 billion profit to the investors who bought the online phone and video-calling service from eBay in 2009. The price Microsoft is paying is 400 times greater than operating income at Skype, which generates surprisingly little revenue per user. See article

LinkedIn, a networking website for professionals, set a share-price range of $32-35 for its initial public offering, which values the company at around $3.3 billion. See article

Details were provided about **American International Group's** forthcoming share offering. The insurance company will sell 100m shares and the Treasury another 200m, thereby reducing the government's stake in AIG to 77%. The offering is at the lower end of market expectations, amounting to $8.9 billion in stock.

Consumer prices in **China** rose by 5.3% last month, down a smidgen from March but still above the government's inflation target. Food prices jumped by 11.5% in April and the cost of clothing increased by 1.4%, the biggest rise since 1997. China's central bank has rolled out a series of measures to try to tame inflation.



Standard & Poor's downgraded **Greece's** credit rating by another two notches. A team of officials from Greece, the European Commission and the IMF is due to report on progress in June, as it becomes clearer that the country's current bail-out package is not working. See article

A new supergroup?

Len Blavatnik emerged the winner from an auction to buy **Warner Music**, with a deal valued at $3.3 billion. Mr Blavatnik made his fortune through his Access Industries conglomerate, which includes stakes in Russia's TNK-BP and Rusal among its assets. Warner, like other music companies, has seen revenue drop with the growth of digital downloads. Mr Blavatnik is rumoured to be interested in buying EMI, which is owned by Citigroup, to create a behemoth in the recording industry. See article

It was a good week for Mr Blavatnik. An arbitration panel ruled that **TNK-BP**, BP's Russian venture, which is half owned by Mr Blavatnik and other Russian shareholders, must be included in a proposed project by **BP** and **Rosneft** to explore

energy fields in the Arctic, if a related share-swap deal between BP and Rosneft is to proceed. The panel laid out other conditions on the deal.

Banks in Britain gave up their legal challenge to claims they had mis-sold **payment-protection insurance** (covering sickness and unemployment) on credit cards and mortgages, and agreed to pay compensation to customers. This followed the decision by Lloyds Banking Group to set aside pound3.2 billion ($5.2 billion) to settle its PPI complaints. See article

Stuart Gulliver, **HSBC's** new boss, confirmed that the bank is to scale back its global business. Only around a quarter of its retail-banking operations provide satisfactory returns, though Mr Gulliver did not say from which countries HSBC would withdraw. The bank is exploring a sell-off of its branches and credit-card business in America, to refocus on corporate banking there.

An 18-month dispute between **British Airways** and its cabin crew that led to the disruption of BA flights last year seemed set to end following negotiations between unions and management.

Not ready to check out

A report submitted to South Africa's competition tribunal said that **Walmart's** proposed takeover of **Massmart** could lead to big job losses if Walmart replaces the South African retail chain's domestic suppliers with foreign ones. South Africa's government and unions are seeking assurances from Walmart that workers will be protected in what will be the company's biggest overseas acquisition since Britain's Asda in 1999.

Apollo Global Management, a private-equity firm, won the contest to buy CKx, an entertainment company that owns the **"American Idol"** television series and has substantial interests in the rights to the name, image and likeness of **Elvis Presley** and **Muhammad Ali**. Apollo's offer of $509m for the business was backed by Lisa Marie Presley, Elvis's only child.

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KAL's cartoon



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The new tech bubble

Irrational exuberance has returned to the internet world. Investors should beware



SOME time after the dotcom boom turned into a spectacular bust in 2000, bumper stickers began appearing in Silicon Valley imploring: "Please God, just one more bubble." That wish has now been granted. Compared with the rest of America, Silicon Valley feels like a boomtown. Corporate chefs are in demand again, office rents are soaring and the pay being offered to talented folk in fashionable fields like data science is reaching Hollywood levels. And no wonder, given the prices now being put on web companies.

Facebook and Twitter are not listed, but secondary-market trades value them at some $76 billion (more than Boeing or Ford) and $7.7 billion respectively. This week LinkedIn, a social network for professionals, said it hopes to be valued at up to $3.3 billion in an initial public offering (IPO). The next day Microsoft announced its purchase of Skype, an internet calling and video service, for a frothy-looking $8.5 billion-ten times its sales last year and 400 times its operating income. And those are all big-brand companies with customers around the world. Prices look even more excessive for fledgling firms in the private market (Color, a photo-sharing social network, was recently said to be worth $100m, even though it has an untested service) or for anything involving China. There has been a stampede for shares in Renren, hailed as "China's Facebook", and other Chinese web giants listed on American exchanges.

Same again, only different

So is history indeed about to repeat itself? Those who think not point out that the tech landscape has changed dramatically since the late 1990s. Back then few people were plugged into the internet; today there are 2 billion netizens, many of them in huge new wired markets such as China. A dozen years ago ultra-fast broadband connections were rare; today they are ubiquitous. And last time many start-ups (remember Webvan and Pets.com) had massive ambitions but puny revenues; today web stars such as Groupon, which offers its users online coupons, and Zynga, a social-gaming company, have phenomenal sales and already make respectable profits.

The this-time-it's-different brigade also points out that the 1990s bubble expanded only after numerous web firms were floated on stockmarkets and naive investors pumped up the price of their shares to insane levels. This time, there have been relatively few big internet IPOs (though that is likely to change). And there is no sign of the widespread mania in the high-tech world that occurred last time around: the NASDAQ stockmarket index, a bellwether for the tech industry, has been rising but is still far below its peak of March 2000.

In one respect the optimists are right. This time is indeed different, though not because the boom-and-bust cycle has miraculously disappeared. It is different because the tech bubble-in-the-making is forming largely out of sight in private markets and has a global dimension that its predecessor lacked.

The bubble is being pumped partly by wealthy "angel" investors, some of whom made their fortunes in the late-1990s IPO boom. Their financial firepower has increased and they are battling one another for stakes in web start-ups (see article). In some cases angels are skimping on due diligence to win deals. When it comes to investing in more established companies like Facebook and the bigger web firms, traditional venture capitalists now face competition from private-equity companies and bank-led funds hunting for profits in a bleak investment environment. Gucci-shod leveraged-buy-out kings may appear to be more sophisticated than the waitresses buying dotcom shares a decade ago-but many of the newcomers are no more knowledgeable about technology.

This boom also has wider horizons than the previous one. It was arguably started by Russian investors. Skype was born in Estonia. Finland's Rovio, which makes the popular Angry Birds smartphone game, recently raised $42m. And then there's China. Renren and Youku, "China's YouTube", supposedly offer investors a chance to profit both from the country's extraordinary growth and from the broader impact of the internet on commerce and society. Chinese web start-ups often command $15m-20m valuations in early financing rounds, far more than their peers in America.

These differences will have important consequences. The first is that the bubble forming in the private market could be pretty big by the time it floats into the public one. Facebook may turn out to be the next Google, and LinkedIn has a fairly solid revenue plan. But they will be followed by less robust outfits-the Facebook and LinkedIn wannabes-with prices that have been dangerously inflated by the angels' antics.

The froth in China's web industry could also lead to unrealistic valuations elsewhere. And it may be China that causes the web bubble eventually to burst. Few of those rushing to buy Chinese shares have thought through the political risks these companies face because of the sensitivity of their content. A clampdown on a prominent web firm could startle investors and prompt a broader sell-off, as could a financial scandal.

And after the angels have fallen?

With luck the latest web bubble will do less damage than its predecessor. In the 1990s internet euphoria caused a dramatic inflation in the price of telecoms firms, which were creating the infrastructure for the web. When internet firms' share prices plummeted, telecoms investors suffered too. So far, there has been no sign of such a spillover effect this time around. But the globalisation of the internet industry means that many more people could be tempted to dabble in web stocks in the current boom, adding to the pain of the bust.

When will that be? This paper warned about both the last internet bubble and the American property bubble long before they burst. Irrational exuberance rarely gives way to rational scepticism quickly. So some bets on start-ups now will pay off. But investors should take a great deal of care when it comes to picking firms to back: they cannot just rely on somebody else paying even more later. And they might want to put another bumper sticker on their cars: "Thanks, God. Now give me the wisdom to sell before it's too late."

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Britain's coalition government

Keep calm and carry on

The coalition has proved stronger and more radical than seemed likely a year ago. It should not lose its nerve



TO JUDGE by recent commentary, Britain's coalition government is fractious, dysfunctional and doomed to collapse-and that is just according to some of its members, after elections on May 5th in which the coalition's junior partners, the Liberal Democrats, were mauled. But take a step back, and the striking thing about the administration that was formed 12 months ago is not its fragility but its robustness. And its success: by and large, the Conservative-Liberal Democrat team has governed well and surprisingly radically (see article). Both David Cameron, the Tory prime minister, and Nick Clegg, his beleaguered Lib Dem deputy, deserve credit-in Mr Clegg's case, much more than he is getting. Amid the ructions, both must stick to their mission to remake the state.

Before last year, Britain hadn't been governed by a coalition in peacetime since the 1930s. Many thought this one wouldn't survive the year, or that, if it did, it would be hamstrung by compromise. It hasn't turned out that way. The coalition addressed its toughest task-repairing the public finances-with an alacrity and decisiveness that impressed governments elsewhere. Fragile economic growth means that George Osborne, the chancellor of the exchequer, might yet have to tweak his fiscal plan; but the outlines of the consolidation, and its mix of public-spending cuts and tax rises, remains broadly right.

At the same time, the coalition has begun to devolve power over the public services and make them more responsive: letting new providers run schools and giving many more of them freestanding "academy" status; handing over power to local councils and voters; fixing the perverse incentives in the welfare system. In most of this, coalition has proved a strength rather than a weakness. That is not just because the only real alternative after the general election was a weak, minority Tory government. It is also because the Lib Dems have tempered some of the wilder Tory impulses, for example on confronting the European Union and restricting immigration. Most of the coalition's problems have had less to do with its complexion than its occasional bouts of incompetence: Mr Cameron's self-confidence has sometimes tipped into insouciance and neglect of detail, as in a botched proposal to privatise forests and, more importantly, the well-intentioned but chaotic bid to make the National Health Service more efficient.

Don't panic and freak out

It is worth remembering the mistaken pessimism that greeted the coalition's birth, and how much it has achieved and might yet, because the prime minister and his deputy now face pressure to become less co-operative (in Mr Clegg's case) and less radical (in Mr Cameron's). They should stand firm.

As well as being battered in the local elections on May 5th, Mr Clegg's party saw its cherished aim of reforming the Westminster voting system thumpingly rejected in a referendum. Mindful of the fate of British liberals in the three coalitions they entered before the second world war-all of which resulted in the party splitting-many Lib Dems want Mr Clegg to prove that they are more than mere Tory stooges, by distancing himself from Mr Cameron's reform agenda.

That would be a mistake. Before the general election, Mr Clegg foolishly pledged to oppose any increase in university-tuition fees; his subsequent (and sensible) reversal of that position explains much of the opprobrium he has received. But his big decision-to enter the coalition-was in the interests both of the country, which sorely needed stable government, and

of his party. Mutinous Lib Dems should remember how absurd they would have looked had they turned down their only chance to wield executive power for generations; and that the coalition has enabled them to implement more of their ideas, for example in taxation, than they ever could in opposition.

The Lib Dems should also remember-and Mr Clegg must remind them-that designing a leaner, more diverse and devolved state is as much a liberal cause as a Conservative one. They should not abandon it for the sake of political posturing that might anyway backfire. The country is unlikely to thank the Lib Dems if they choose to emasculate the government-but it might eventually reward both parts of the coalition for shaping a more efficient and responsive state.

Cruel to be kind

For his part, in the intangible but crucial matter of demeanour, Mr Cameron has fit the office of prime minister in a way that Gordon Brown, his immediate predecessor, never did. Besides his occasional fumbles on policy (and a strange fondness for intellectual gimmicks, such as the "Big Society", an unhelpful slogan for his ideas), Mr Cameron's main weakness is a yearning to be liked. The risk now is that he tries too hard to ingratiate himself with the Lib Dems, soft-pedalling his reforms as a sop to Mr Clegg's fracturing base.

There is certainly room for refinement in the government's plans for the NHS. For example, it could phase in the transfer of spending powers to family doctors and make that new responsibility voluntary at first. But Mr Cameron mustn't compromise on the basic principle of injecting more competition into the provision of hospital care, an approach first introduced in Britain by the previous Labour government, considered utterly unremarkable in most European countries, yet suddenly regarded as unpalatable by many British politicians (including, it seems, some Tories who are overly queasy about seeming right-wing). The same goes for opening up other public services to private and voluntary providers: a white paper on the subject has been ominously delayed.

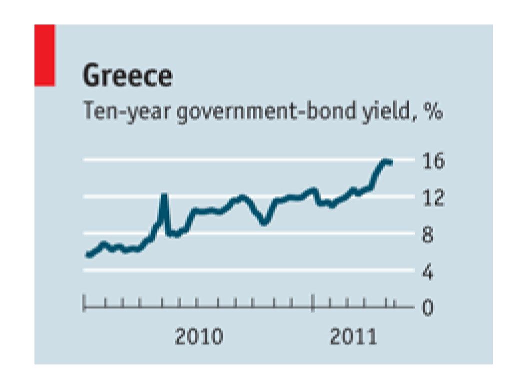
There is scope to go much further. The welfare system is still more of a comfort blanket (for rich pensioners, for example) than the safety net it ought to be. Allowing education outfits to make a profit from running new "free" schools would encourage more applicants: Mr Cameron should reconsider his reluctance to let them to do so. Such reforms are decades overdue. If they stall, the coalition could yet fizzle out in failure. But if Mr Cameron and Mr Clegg hold their nerve-and cut out the unforced errors-their novel, improbable government could prove one of Britain's boldest.

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Greece's debt crisis

Trichet the intransigent

The European Central Bank's refusal to consider a restructuring of Greek debt could wreck the euro zone



IF THE stakes were not so high, Europeans' incompetence in the euro-zone debt crisis would be comic. One year after the Greek rescue was launched, it is manifestly failing (see article). Yields on ten-year Greek bonds are higher than they were a year ago. Both the Greek government and its European and IMF rescuers admit that the country has no hope of tapping private capital markets in 2012, a central assumption of the original plan. It is plainly time for Plan B. But rather than get on with it, Europeans are bickering like children in a playground.

The biggest fight is between Germany and the European Central Bank (ECB). Germany's politicians do not want to lend Greece more money without a "game-change" in the rescue plan. That could include bold new concessions from the Greeks, such as pledging privatisation proceeds as collateral for new rescue funds. Or it could imply a debt restructuring. Although the Germans are reluctant to impose losses on holders of Greek bonds, they have become convinced that a "reprofiling" of the country's debt is advisable.

The ECB is adamantly opposed. It wants to continue with today's failed plan, with more Greek austerity in return for more loans. The bank's officials have argued, in increasingly hysterical tones, that any tampering with Greek debt, even a modest extension of maturities, would be a catastrophe. One has predicted it would cause a crisis far worse than the collapse of Lehman Brothers in 2008. Privately, ECB officials are even more extreme, threatening that if Greece restructures its debt, they might refuse to allow Greek bonds as collateral for funding by the ECB. Such a withdrawal of liquidity would doom the country's banking system and might even lead to Greece's departure from the euro zone.

It is certainly reasonable for the bank to worry about the impact of a Greek default on the European banking system and its own balance-sheet, and about the risk of further defaults in Ireland, Portugal and even beyond. But rather than digging in its heels, the ECB should insist that Europe's politicians reduce those risks by coming up with funds to recapitalise hard-hit banks. Perhaps, in a calculated piece of brinkmanship, the ECB hopes that by raising the stakes around a restructuring it can persuade Europe's governments to blink first and provide more cash for Greece. That would be risky. The still more alarming possibility is that, blinded by pride, the bank and its hitherto sensible president, Jean-Claude Trichet, are unable to accept that a euro-zone country is bust.

Whatever the ECB's motives, the Germans are right. When Plan A is clearly not working, there is no point in pigheadedly pursuing it. That means looking for a plausible Plan B.

Blind bank's bluff

A privatisation-for-loans scheme is not a serious short-term option, both because there is plenty of opposition in Greece to a fire sale of assets and because the Greek government doesn't have official title to much of the land it plans to sell. So, in practice, Plan B involves going in one of two directions: either other EU members must give Greece enough money, for long enough, to reduce its debt burden to a sustainable level, or that debt must be restructured. It is hard to imagine Europe's taxpayers accepting a drip-feed of endless transfers to Greece. That leaves restructuring as the only sensible way forward.

It is time for the Germans and the IMF to call the ECB's bluff. Together they should demand, and instigate, a restructuring of Greek debt. Germany should push other European governments to cough up money to support Greek banks and, if necessary, to make whole the ECB. The fund, which knows how to restructure debt, must ensure the process is run in a competent manner. The ECB will then be faced with a choice: go along with an orderly restructuring, or trigger a much greater mess by in effect forcing Greece out of the euro zone. Surely Mr Trichet does not want that to be his legacy.

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The Afghan campaign

Single or quits

Afghanistan is doing a little better; Barack Obama should not rush out of it



AMID the wreckage of broken promises and failed plans that litter the ten-year mission in Afghanistan, the only certainty has been the campaign's capacity to disappoint. Rotten government, a vast cost, resurgent Taliban and the mounting death toll all argue that this is a patch of dusty ground where the outside world has overstayed its welcome. Now the killing of Osama bin Laden has at last satisfied one of the war's chief aims. Barack Obama is to assess troop levels in Afghanistan as part of a long-scheduled drawdown in July. Why shouldn't America's president declare victory and pull out fast?

Tempting as it is, that would be a mistake. The coalition has set the end of 2014 as the deadline for the Afghan government to take charge of security. That is still the date to aim for, because it gives scope for an Afghanistan that will be broadly stable. In July Mr Obama can certainly pull out a few thousand of the 90,000 or so troops he has there, to meet his pledge. But for the outside world rapidly to withdraw military and financial support would invite collapse inside Afghanistan and strife across the region. History has shown where that leads.

In the past presidents pondering what to do in Afghanistan needed either to put in more resources or to stomach a humiliating retreat. But Mr Obama is not being asked to double up; just to stick to a decent plan. As our briefing this week explains, the country is certainly not set to become the 21st-century democracy that the West dreamed of a decade ago-where girls go to school and women are free of the burqa; nor is it likely to have shed violence and corruption by 2014. But it is on course to becoming a markedly better place than it was, with the chance eventually of peace with the Taliban, steady relations with its neighbours and better treatment of its citizens.

The improvement is partly thanks to the "surge" of 30,000 troops, which Mr Obama reluctantly endorsed in 2009. The extra forces, under General David Petraeus, America's most successful serving commander, have helped to dampen the insurgency. It also reflects better governors and civil servants in some parts. And it is thanks to the Afghan army and police, who now number 285,000 and are better trained and educated than they were. Just this week, they put down a raid by at least 40 Taliban gunmen and suicide-bombers in Kandahar.

Two worries present themselves. The immediate one is that these gains are fragile. The summer will surely bring a resurgence in fighting by the Taliban. Government in some regions remains dire. Corruption is ubiquitous-witness the recent escape by at least 475 Taliban from a jail in Kandahar. All this argues both for making the troop withdrawal this year largely symbolic and for training still more Afghan security forces.

The second worry is what happens in 2014-or soon afterwards. The puppet government that the Russians left behind in 1989 collapsed three years later. But that regime was not overwhelmed by the insurgency: it was abandoned by the bankrupt Soviet Union. An Afghan government could see off today's insurgents, who are weaker, worse armed and less popular. Although support for the Taliban is high in some regions, only 13% of all Afghans back them. Even if many Taliban resist a political settlement right now, a stable, inclusive government in Kabul might gradually persuade them to peel off.

That is why even after 2014 Afghanistan will need 25,000-35,000 foreign troops and aid of several billion dollars a year. This would be a serious commitment, but it would be a fraction of the $120 billion that the United States alone has provided this year. And foreign troops would play a supporting role, in which they faced less danger and were more removed from the contact with Afghan civilians that has fed the insurgency.

Much could go wrong. President Hamid Karzai is supposed to give up power in 2014. Corrupt and weak, he might seek to hang on. That would be as big a setback as his rigged re-election in 2009. The outside world needs to bolster the presumption that Mr Karzai will go. Worse still is the threat from Pakistan (see article). Its security forces cannot be trusted. Even so, America must hold its nose and engage with Pakistan and press it to act against the Taliban. Some influence is better than none at all; and some Pakistanis are starting to realise that the Islamists they sponsor in Afghanistan feed terror at home.

Hard but necessary

In short it is all connected. Abandon Afghanistan to the wolves and you increase the chance of Pakistan sliding still further downwards. By contrast, the more America stabilises Afghanistan, the more that helps steady the region too. From the view of 2001, none of this looks like victory in Afghanistan. But compared with the power vacuum and disruption created by suddenly pulling out, it would be a triumph.

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Fixing international banking

Unfinished business

Banking is a lot safer than it was. Sadly more still needs to be done



THE financial crisis was fought at the weekends. In sweat-stained shirts, fuelled by stale coffee and cold pizza, harried officials worked the phones and held emergency meetings with other bankers to discuss whether to save this bank or to let that one sink-all before markets opened on Monday. The Sunday scrambling reflected the fact that officials had too many fires to put out and too few good options to choose from.

Before the crisis, regulators hoped that the discipline of markets would ensure banks were sensible in the risks they took. That proved to be a vain hope, in part because markets are prone to exuberance and in part because many banks had become so large that they could not be allowed to fail-and they knew it. The emphasis now is on drawing up a new rule book for finance (see our special report). In America, the world's biggest financial market, the Dodd-Frank act is reversing decades of deregulation. In Britain officials are pondering plans for banks to erect firewalls between the different parts of their businesses. All banks will be required to hold a lot more capital to protect them against unexpected losses. New rules on funding and liquidity will force them to keep more liquid assets that can be easily sold should they need to raise funds urgently. These measures are making banking safer than it was. But the job is still far from complete.

To make banking safer, regulators need to marry two seemingly contradictory aims. The first is to make it less likely that banks will fail in the next crisis. The second is to make it less painful for taxpayers when they do fail. On the first, the biggest gains come from raising liquidity and capital standards-and here there has been plenty of progress. The new Basel 3 rules will have the effect of doubling the amount of core equity that a typical big bank holds as a proportion of its assets. The standards come into full force only in 2019 but the market is making banks plump up their capital cushions far sooner. Had Basel 3 been in force before the crisis most big banks would have been sufficiently stocked up on capital.

Most, but not all. Only a handful of big firms, out of a couple of hundred worldwide, suffered net losses that the new Basel standards would have been unable to deal with. Forcing all banks to hold enough equity to ensure that even the worst outliers-think Irish banks-are safe is an option from the ivory tower. The amounts needed would harm banks' capacity to lend, fail to discriminate between well-run outfits and badly run ones, and encourage risks to migrate out of the regulated banks to the shadow-banking system (another area that still needs lots of work). Regulation, even in a business as dangerous as banking, should be restrained and targeted.

A little layer cake in Basel

A bit more equity is sensible for banks that are interconnected and large enough to cause serious economic damage if they collapse. The simplest way of doing this would be to insist on a chunky capital surcharge for systemically important banks. The Basel committee should look at the debate under way in Britain, where an independent commission has proposed an additional equity buffer of 3% for big retail banks.

The other thing that regulators need to do is soften the blow when banks do get into trouble. Most countries are putting in place resolution regimes that allow regulators to shut down smaller banks. But letting a big retail bank close its doors completely is still unthinkable. The real task is finding a way to impose losses on banks' owners and creditors rather than making calls on taxpayers.

Tools are being developed in the form of convertible-capital instruments and bail-in debt, whereby creditors of struggling banks are turned into shareholders if losses rise high enough. Swiss regulators, for example, want their biggest banks to hold the equivalent of 9% of their risk-weighted assets in convertible capital. The advantage of these instruments is that losses fall where they ought, on those who funded the banks, and that they provide a ready-made pool of capital that is cheaper than equity and large enough to recapitalise all but the most extreme failures. Questions swirl around these new instruments. Is there enough demand for them? Will they stop the problem of creditors running for the hills at the first sign of trouble? But a thick buffer of equity and convertible debt is the best way to make crisis-filled weekends less terrifying.

The not-so-beautiful game

Offside

Time to blow the whistle and put the right to host the World Cup on eBay



WHEN it comes to long, rancorous and pointless rows, few things are in the same league as the world's favourite sport. (Note to American readers: we speak of the game you call soccer.) Arguments rage for days-decades-after the final whistle. Was the ball over the goal-line? (Note to German readers: maybe not at Wembley in 1966, yes in Bloemfontein in 2010.) Was that sending-off deserved, or a gross miscarriage of justice? Was the referee brilliant, blind or bribed?

Off the field, it's the same. Five months ago 22 members of FIFA's executive committee voted to stage the 2018 World Cup in Russia and the 2022 tournament in Qatar. People in England, which had hoped to be host in 2018, are still crying "Fix".

And not just on the terraces. This week Lord Triesman, an establishment figure who chaired the English bid until he was recorded making allegations about rival bidders' propriety, gave his version to MPs. He said that the behaviour of four committee members had been "below what would be ethically acceptable". One allegedly asked for millions of pounds, channelled through himself, for an educational establishment in his home country and giant screens on which earthquake-stricken Haitians could watch the World Cup; the second wanted a knighthood; the third told the English "to come and tell me what you have got for me"; the fourth wanted television rights for a match between his country and England. The MPs also published an (unproven) allegation unearthed by the *Sunday Times*, a British newspaper, that Qatar had paid two other members large sums for votes. The accused all deny wrongdoing. Sepp Blatter, FIFA's president, whose long reign has seldom been short of controversy, says he'll look into it all.

Granted, the English are suffering from a bad case of sour grapes. By any standards, they made a mess of their bid, their football establishment is a disaster and their footballers now dive almost as often as continental ones, though sadly without the theatrical grace. But the world badly needs a more open way of choosing the host of the World Cup.

Already suggestions are coming forward. One is to make votes open rather than secret. Another is to give FIFA's 208 national associations a vote each-as they will have in a few weeks when Mohamed Bin Hammam (of Qatar, would you believe) challenges Mr Blatter for his job. *The Economist* has another idea. Auction the thing. And do it publicly.

The far corner

An auction would do two things. First, by making sure all the moolah went to FIFA, it would place committee members (with no votes to sell) above suspicion. Second, it would force bidders to work out how much the competition was worth to them. At least in democracies, that might not be very much, judging by past World Cups.

If oligarchs, sheikhs and other rich fans still want to pay for a party, fine. And if governments wanted to take bread from their people to pay for a football circus, they would at least have to admit how much. As for the location of the auction, where better than eBay, the leading online seller of second-hand goods? Fans around the world could watch agog as the deadline neared and bids rose. Better still, FIFA could flog the rights for reality TV.

Spoilsports will come up with all sorts of objections. Mightn't this be a tad undignified? Perhaps, but football lost its dignity long ago. Wouldn't an auction discriminate against poorer countries? Yes, but that is easily fixed by continuing to rotate the competition by continent (so Africa still has its turn). And wouldn't all the treasure going to FIFA provide scope for corruption as it is disbursed? Once again, transparency is the answer. Publish online all the details of where every penny is spent. It is a little like goal-line technology, Mr Blatter. We know that an honest, eagle-eyed referee like you would never need it, but just in case...

Index | Letters

Letters

On California and democracy, Greek debt, Japan, Canada's election, aphorisms, Turkey, syntactic bliss

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Letters are welcome via e-mail to letters@economist.com

More power to the people



SIR - I read your special report on democracy in California, which you described as "dysfunctional" (April 23rd). Let me state at the outset that all 24 states that allow citizen initiatives have bad laws. However, your reference to the referendum as a tool of direct democracy underscored the paternalistic tone of your report.

Legislating by referendum is not direct democracy, but rather a device used by a representative government to submit a measure to the electorate for an up-or-down vote. As a result, politicians control the process, which they continually limit or corrupt. More fundamentally, the structure of representative government keeps citizens in civic adolescence. We want the largesse of government, but are reluctant to pay for it. We give away our policymaking powers to elected politicians on Election Day, and then we blame them when things go wrong. That is the definition of civic adolescence. If citizens became deliberative lawmakers, they would be forced to take responsibility for the polices they help to enact. This would bring about a process of civic maturation, a development that could only benefit all facets of human life.

There are only two possible venues for change: our elected representatives, wherein the problem exists, or we can look to the people. Our dilemma is that all our efforts to improve governance are attempted within the context of representative government, by which we continue to believe that electing the right people to public office will bring about structural improvements. This has proven not to work.

The answer to the problems of governance in California and in the nation lies with the people, not with their leaders.

Mike Gravel
Chairman
Democracy Foundation
Burlingame, California

SIR - Winston Churchill thought that one of the best arguments against democracy was a five-minute conversation with an average voter. Your leader on "The perils of extreme democracy" (April 23rd) bemoans a situation where those average voters seem to have something to say in a referendum every five minutes. But that doesn't mean they get their way.

In Missouri last year voters approved a proposition to toughen the regulation of the state's abusive puppy mills. Soon after it passed, however, the newly elected legislature, with many representatives from rural areas, where breeding puppies is a profitable enterprise, voted to gut the meat of the proposition.

Jamie Spencer
St Louis

SIR - As H.L. Mencken put it, "Democracy is the theory that the common people know what they want, and deserve to get it good and hard."

David Pearse
Tucson

* SIR - Regarding the perils of direct democracy, as a newspaper reporter in Spokane in the 1950s, I was assigned to help gather signatures for "a petition supporting capital punishment."

We easily collected 50 from crowds at downtown bus stops. Stripped of its obfuscating verbiage, the document, which nobody read, was a petition to the governor of Washington state "to hang the undersigned by the neck until dead."

George Cheek
Camas, Washington

* SIR - California should hold a Proposition 0, whereby we scrap all previous propositions and start all over again.

Manuel Gomez
Baden, Switzerland



SIR - If California is all that bad, why is the population increasing so rapidly? The state of the Golden State is just fine. California has made the greatest advances in the most important technologies, ever. Just think: NASA's Jet Propulsion Laboratory, Caltech, Stanford, the University of California system (to name far too few), let alone Silicon Valley and Hollywood. We are also the most culturally diverse nation-state in the world.

Daniel Bernard Wolfberg
Los Angeles

Poland's lesson for Greece

SIR - When pondering the Greek debt crisis you were right to suggest that "the economics point to...a steep write-down as part of a broader package of reforms" (Economics focus, April 23rd). Yet I am not sure why you drew an analogy with Uruguay in 2003? A better example would be the case study of restructuring Poland's non-performing foreign debt.

As finance minister I signed in 1994 a pragmatic accord with the London Club. It was not easy to strike the deal, but it did work. Half of the outstanding debt was written off and paved the way for the smooth service of the remaining obligations. This came with very tough conditions and enforced far-reaching structural reforms.

The difference is that in the case of Greece it is not only the matter of outstanding foreign debt, but forthcoming domestic insolvency, too. Hopefully our Greek friends have learnt by now that the inescapable invoice has already arrived.

Professor Grzegorz Kolodko
Kozminski University
Warsaw

Canada's election



SIR - Your leader on Canada's election diminished the talents of Michael Ignatieff, the leader of the Liberals ("Groundhog day", April 30th). Yet Mr Ignatieff ran an excellent campaign, held numerous town-hall meetings where he spoke eloquently and welcomed questions and debate. You have described Mr Ignatieff as "wooden and snooty" on the campaign trail ("Here we go again", March 26th), though that much better applies to Stephen Harper.

It seems that you, like many Canadians, have succumbed to five years of relentless character assassination from Conservative attack-ads on Mr Ignatieff's motivation, abilities and personal relationships.

Janice Shewchuk
Nanoose Bay, Canada

SIR - You chided Mr Harper for his alleged intransigence on regulating Alberta's oil sands, which you called "an especially dirty business". Yet greenhouse-gas emissions from Alberta's oil-sands industry account for only 5% of Canada's emissions and less than one tenth of 1% of the world's. On a well-to-wheel basis, oil-sands emissions are broadly comparable to a range of conventional sources of crude.

Moreover, just 6% of Canadians identified the environment as the most important issue during the election.

Todd Weiler
London, Canada

The market for electricity



SIR - I agree with your assessment that Japan's government has many options for dealing with the electricity shortage caused by the earthquake and tsunami ("A cloud with a green lining", April 30th). As you say, it could encourage solar power, subsidise LED lighting, push for batteries to shift demand away from peaks, etc.

Alternatively, it could do nothing at all, and allow consumers to bid for the rising price of electricity until demand drops to meet the limited supply. The resulting high price would by itself encourage alternative sources of supply and force conservation without any need for "publicity" or nagging. And without costing taxpayers a penny, or feeding subsidies to the politically connected.

Dave Lindbergh
Reading, Massachusetts

Ancient proverbs

* SIR - Your briefing on Chinese entrepreneurs in Africa quoted a "Chinese aphorism": "One cannot step into the same river twice" ("Trying to pull together", April 23rd). Actually, this is usually attributed to Heraclitus, a Greek pre-Socratic philosopher.

John Greppin
Cleveland Heights, Ohio

Mildly Islamist

* SIR - For several years your newspaper has been addicted to modifying any mention of the ruling AK party in Turkey with the adjectives "mildly Islamist" (most recently in "South by south-east", April 16th). Leaving aside the argument over whether this phrasing is as logical as, say, "somewhat pregnant" or "moderately devoted to global warming," I note that such adjectival editorialising is not applied to other, less favoured movements.

Perhaps in the future *The Economist* may see fit to extend this apologetic regime to other groups. I suggest, for a start, referring to the "mildly constitutionalist tea party" and the "lukewarm pro-life/heterosexual" Catholic hierarchy.

Timothy Furnish
Woodstock, Georgia

O frabjous day!



SIR - I have noticed some wonderful little moments of syntactic bliss in your pages recently, made even more pleasurable by the peculiarities of British (as opposed to American) English: "To escape the technological flimflammery of the modern world"; "cardiganed beardies"; "the network that debouches into the Pearl River delta"; "in less competitive markets, even fewer need to be nobbled"-I have a notebook full of these wiggy darlings.

But I want to give special thanks for this: "The research offers more than just an insight into the life cycle of subsea gribblies" ("Ocean-floor migration", April 30th). For me, those gribblies are a lark in the California desert.

J.L. Bautista
Berkeley

* Letter appears online only

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Afghanistan

Glimmers of hope

It's been a long slog, but Afghanistan may at last be able to contemplate more stable government



THE blast annihilated the back of the Humvee, leaving a smear in the desert. "Every time we venture that far out, we get hit," says Captain Aaron Tapalman of the US Army, who is responsible for Sabari district in Afghanistan's Khost province, near the border with Pakistan. The roadside bomb had exploded under the Afghan army vehicle, killing two soldiers and seriously wounding three.

Khost lies across infiltration routes from Pakistan's tribal areas, but much of the insurgency is local. "Most of the villages just want to be left alone, and some of them are clearly pro-Taliban," says First Lieutenant Eddie Fox in neighbouring Bak. His outpost is often pummelled by rocket fire. The influence of the Haqqani network-eastern Afghanistan's leading insurgent organisation-is strong. They are said to have been behind a number of terrorist attacks in Khost and operate there as a mafia. Many local leaders are hedging their bets. "To be frank, we are afraid of both sides," says a man in a nearby village.

In a place like Sabari, the efforts of the 140,000 troops of ISAF (NATO plus a coalition of the willing) look distinctly unpromising. American forces there are struggling to expand their "security bubbles"-the relatively secure zones around coalition bases. These intensively patrolled patches often cover only a dozen or so square kilometres in the most hostile parts of the country.



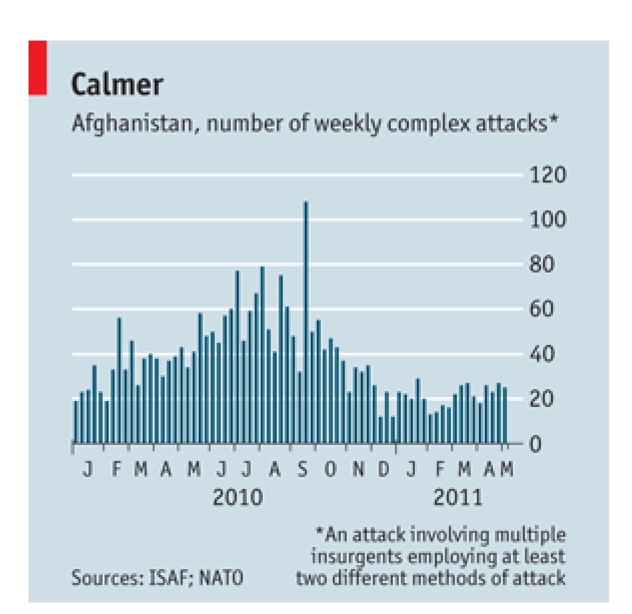
Yet for David Petraeus, the American general in command of ISAF, keeping watch on the country from his gloomy office in Kabul, Sabari is an example of where the coalition has finally "got the inputs right". His argument is that the extra troops ordered to Afghanistan in late 2009 by Barack Obama have allowed ISAF to move into troublesome areas like this

for the first time. They have also put the cost of the military effort up to eye-watering levels. The American army alone is spending nearly $120 billion a year.

"No one denies the progress that has been achieved in the security arena in the last six to eight months," the general says. Certainly the American reinforcements have changed the face of the war. In many difficult areas of Helmand and Kandahar ISAF's forces have become much more aggressive. A senior NATO intelligence officer says the troop surge, together with an "unprecedented" increase in night raids by special forces against mid-level Taliban leaders, has left the insurgents dazed. Huge numbers of weapons caches have been destroyed, and it is hoped that Taliban fighters attempting to reinfiltrate for the summer fighting season will struggle to win local support.

NATO's electronic eavesdropping and networks of informants have discovered that some Taliban commanders are afraid to return to the fight, and have had flaming rows with senior insurgents directing fighting from the safety of Pakistan. One piece of intelligence even suggests that Mullah Omar himself, the one-eyed leader of the Taliban, is deeply alarmed by the rapid expansion of the Afghan Local Police (ALP), an auxiliary patrol force supervised by American Special Forces. So far 39 units are up and running and 37 in the pipeline. General Petraeus says there is "no question" that the ALP is making a big impact, although critics fear that this "militia" may inevitably turn on the population it is supposed to serve.

According to the general, some insurgent groups are also increasingly interested in a reintegration programme under which fighters give up their arms in return for an amnesty and some vocational training. But so far just 1,200 have gone through the programme, mostly in northern Afghanistan, with another 1,700 considering it: a drop in the ocean in an insurgency estimated to be 35,000 strong. NATO does not expect local peace deals to have any effect until the end of the year.



Meanwhile, violence is relentlessly rising. NATO analysts predict that 2011 will be the most violent year ever, with incidents possibly up by 30%. Nic Lee, director of the Afghanistan NGO Safety Office, sees "a perpetually escalating stalemate". But General Petraeus is sanguine about this, too. He attributes the rising level of violence to the fact that the extra Afghan and NATO troops have provided "100,000 more targets than last year". He also highlights a decline in "complex attacks" involving more than one assailant (see chart). Is it a turning point? "This is something you see in the rear-view mirror, not through the windshield," he says.

Talking to the Taliban

Yet with a large population of young men living over the border in Pakistan and radicalised by what one Afghan official describes as "hate madrassas", some fear that the supply of potential insurgents is almost limitless. For Hanif Atmar, a former interior minister, as long as the Taliban enjoy such sanctuaries, "they cannot be defeated". Many agree, and think that the only way forward is for America to enter peace talks with the Taliban.

In February Hillary Clinton publicly committed the United States to a "diplomatic surge" to bring the conflict to an end. Some Taliban apparently found this confusing, just as the military surge was increasing pressure on them. Nonetheless, around the country ISAF is already showing enthusiasm for engaging with local Talibs. In Ghazni, a province in the south-east suffering some of the worst violence in the country, the education director sat down with the local Taliban

earlier this year to thrash out what should be taught in schools-agreeing in the end, surprisingly, to keep the official curriculum unchanged.

Some analysts think the killing of Osama bin Laden has opened a window of opportunity. "The Taliban know they made a lot of serious mistakes in their government, using the Islamic faith in the wrong way," says Ahmad Shah Ahmadzai, a former prime minister in the *mujahideen* government of the 1990s that was later overthrown by the Taliban. "They have made a lot of corrections. They will not be a threat to anybody."

Even the Pakistanis may, some think, support talks. The Pakistani ambassador in Kabul still laughingly denies the suggestion that the Taliban is anything other than an Afghan phenomenon; but for everyone else it is an accepted fact that Pakistan promotes the Afghan Taliban in order to avoid the emergence of a strong state backed by India (see article). According to Afghan officials, Pakistan explicitly laid out the "price of peace" in a recent meeting between Yusuf Raza Gilani and the Afghan president, Hamid Karzai, with the Pakistani leader urging his counterpart to abandon his alliance with America and the West in favour of stronger ties with its neighbour and with China.

Now the thinking is that the Pakistanis may change their tune if the coalition continues to batter the Taliban for a bit longer. "It may be that Pakistan is thinking to itself, 'If we are not careful we are going to find that one of our main assets is actually eroding before our eyes, so maybe we'd better start talking'," said one diplomat.

Yet this seems, in the end, a forlorn hope. There are precious few signs that the Taliban are ready to talk, despite strenuous efforts to engage them by Mr Karzai. Acting on advice from ministers of the former Taliban regime, he has set up a High Peace Council to make contact with the insurgents, and has tried to arrange the release of Taliban prisoners held on the basis of flimsy intelligence. He is also trying to find a country outside the region that could host a Taliban "office" where they could meet the government and NATO representatives without fear of arrest. But despite all these overtures, no positive response has come from Mullah Omar.

And even if the Taliban show willing, the obstacles in the way of a politically acceptable settlement are formidable. Only last week at least 10,000 protesters, waving green flags, mobilised in Kabul to protest against "dealmaking" with the Taliban. It was an impressive display of power by Amrullah Saleh, the country's articulate former intelligence chief, and his "anti-Taliban constituency"-a group apparently dominated by non-Pushtun northerners, who fought hardest against the rise of the Taliban in the 1990s. Mr Saleh hints that peace with the Taliban could mean the remobilisation of northern factions that were supposedly disarmed after 2001. "Don't push me to take a gun," he said after the rally. "It is very simple."

The Russian ambassador in Kabul, Andrey Avetisyan, who served as a political officer during the Soviet occupation, thinks any attempt to make a quick deal could end in "civil war". Reconciliation, he says, must be done very carefully, and a final deal may take years.

Training up the Afghans

Even if peace talks fail to offer a quick way out for the West, and General Petraeus's campaign fails to deliver a killer blow to the insurgency, the vast majority of ISAF troops will nonetheless leave by the end of 2014. What happens then?

According to the country's "transition" plan, the Afghan National Army (ANA) and police (ANP) will be expected to take the lead in providing security all over the country by the end of 2014. The National Military Hospital in Kabul is full of young soldiers and policemen, lying listlessly on their beds or learning to walk with prosthetic legs, who have sustained horrific injuries but still say they are proud to have served their country. Can these patriotic Afghans do the job NATO's high-tech armies were unable to finish?

Mr Atmar, the former interior minister, does not think it is as hopeless as it sounds. Put crudely, it has been done before: in 1989, when the Soviet army pulled out of Afghanistan. Remarkably, the regime they left behind managed to hold on to power for more than three years-and this at a time when the rebel *mujahideen* were far more popular than the Taliban are now (only 13% of Afghans view them favourably, according to the UN). The regime would never have fallen, Mr Atmar says, if the vast subsidies on which his forces relied had not dried up when the Soviet Union collapsed. For Mr Avetisyan this is the "biggest lesson" of the Soviet occupation.

The annual cost of Afghan security forces after 2014 has been estimated at $6 billion-8 billion. Adding to that huge cost will be the expense of the continuing Western military mission, which will include special forces and "enablers" to help

the Afghans with such things as intelligence. Numbers have not yet been decided, but David Barno, a former commander of American forces in Afghanistan, has recommended a "sustainable limited presence" of between 25,000 and 35,000 men.

This presence will also, it is hoped, persuade many insurgents and meddling neighbours that they cannot wait out the foreigners. But Mr Atmar points out that the Soviets "invested properly" in the Afghan army, kitting it out with more tanks, planes and helicopters than most other countries in the region. By contrast, the Americans "only decided that Afghanistan needed an air force last year." They have to invest more in Afghan capacity and damn the cost, he argues. But they will also have to stay, in part, to restrain this well-stocked new army from attacking its neighbours.

The Americans recognised the need to invest more about 18 months ago, when William Caldwell, an American general, took charge of the NATO Training Mission. When it began, it had two nations and 30 trainers; it now has 32 nations and more than 1,300 trainers. Asked whether the Afghans will be ready to take over security in 2014, General Caldwell says: "Unequivocally, yes." The army, police and air force combined are now 285,000-strong; by December 305,000 should be trained and in the field. Attrition rates have declined; the police and the army now get 6,000-9,000 recruits every month, and keep most of them. And although only 14% of new recruits can write their names, General Caldwell hopes that the literacy rate in the Afghan forces will have improved to around 60% by the end of the year.

Much of the security of greater Kabul, where a fifth of Afghans live, is already largely in the hands of Afghans, including Afghan special forces who conduct up to three raids a night. Even the sustained attack on May 7th-8th in Kandahar city was mostly put down by Afghan security forces. The reduction in foreign troops could help damp down the war; some Taliban foot soldiers have said they would not fight against fellow Afghans as they do against the infidel invaders.

The non-rule of law

The abiding problem is that Mr Karzai remains in charge. His relations with the Americans are now soured by years of mutual mistrust, and it hard to imagine that he can hold everything together. "He has disowned this war for reasons of political expediency and personal grievances," says one of his former cabinet colleagues. "He will never forgive the Americans, and they won't forgive him."

In theory Mr Karzai is meant to step down in 2014, after two terms. In practice he may bend the constitution and stay. And although there have been some modest improvements in the way Afghanistan is governed, the country as a whole remains mired in corruption. ISAF's funding is vast compared with the size of the Afghan economy, and much of that money sloshes dangerously around inside the country. Large sums go to contractors who may pass them on to the Taliban, or to drug-runners, to pay for supplies and protection, especially in the south. The rule of law is patchy: many Afghans shun government courts, preferring the swifter, cleaner justice of informal Taliban tribunals.



Nation-building, brick by brick

The writ of the Afghan government extends much further than in the days when Mr Karzai was dismissed as "the "mayor of Kabul". But although an army of civilian experts was promised to help reinforce the Afghan government, little has been achieved. "The Obama civilian surge has been a complete failure," says one American official working in the south-east, who complains that none of the promised half-dozen experts in agriculture, rule of law and development ever turned up. Either they were not recruited, or they were "stuck in Kabul or Bagram". One project that got off the ground in the city of Ghazni was an 80-metre ornamental barrier built down the centre of a road by USAID for $100,000. The governor was so unimpressed that he built another 80 metres for $10,000 just to prove a point.

Ministers in Kabul and governors in the provinces still do not work well together, with provincial officials constantly complaining about the difficulty of getting money from the capital. In the most violent provinces governors struggle to compete with tribal power-brokers, fat on the profits of drug-smuggling and military contracts. District governments often have no operating budget to pay for staff and basic supplies, even assuming there is an office for the governor and his team to sit in. In Khost the governor is so scared of assassination that he rarely appears, and 50 of the 53 government positions are unfilled.

If things work at all it is usually because of Provincial Reconstruction Teams (PRTs), the civilian-military units run by individual ISAF countries. In Helmand the PRT runs the "District Delivery Programme": the British government lodges $9m of aid with the Ministry of Finance in Kabul, which officials in Helmand then ensure is spent on district government through a mixture of "persuasion and encouragement", in one official's words. It took nine months for the first penny of the $9m to get down to district level.

Mr Karzai constantly criticises the PRTs as an "alternative structure" outside his government. In February he called for them to be closed down. But "all the governors I speak to say that without the PRTs nothing would happen in their provinces," says one exasperated UN official.

Settling for less

In Pushtun areas of Afghanistan especially, the Karzai government is seen as an intruding and corrupt foreign power: Persian-speaking Kabulis backed up by white foreigners. Captain Steve Baunach, a civil-affairs adviser in Khost, says his task is to convince people to support the government instead of the Taliban. "But I'm struggling because I don't have a convincing story to tell them. There are not enough police, no budget, no services." Besides, local Pushtu tribes have always governed themselves. Some NATO advisers think a genuine local government could be built up based on tribal organisations; but after decades of war the tribal system, too, is in a pitiful state, with some elders locked in conflict over land and women.

Western officials are under no illusions that Afghanistan can become a 21st-century state. Attacks by insurgents are likely to continue for years to come. But Simon Gass, NATO's senior civilian representative in Kabul, thinks "the question is, can they be contained by the Afghan security forces, with whatever extra help they need, in a way that makes sure this level of violence does not pose a threat to the existence and authority of the Afghan state? That is what we are looking for and I think it is achievable." A messy transition to Afghan control looks the most likely, and least worst, outcome.

Back in Khost Colonel Chris Toner, the man in charge, is also cautiously optimistic. He points out that the surge has only just started there. He says some tribes are co-operative. In Jaji Maidan district, locals keep the Taliban out. For all the violence in Sabari, the outpost has suffered far fewer attacks than last year. Colonel Toner says enemy control of the province has weakened since 2010. There is a long way to go; but, slowly, they may be getting there.

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The budget

The Blair House Project

The White House and Republicans agree on where to go. They now have to work out how to get there



BUDGET-MAKING in America is an exercise in brinkmanship. Last December Barack Obama and Republican leaders in Congress narrowly avoided a sharp rise in tax rates. Last month they averted a government shutdown with barely an hour to spare. They returned to the table on May 5th with another deadline looming: they must raise the ceiling on the national debt by August, or else make the federal government default on its obligations.

Judging by their public postures, the prospects look poor. On May 9th John Boehner, the Republican speaker of the House of Representatives, called for "trillions, not just billions" of spending cuts as a condition of raising the debt ceiling above its current $14.3 trillion. He suggested he would rather let the government default than fail to cut spending. Mr Obama's spokesman responded that "maximalist positions do not produce compromise."

The two sides may not be as far apart as the rhetoric suggests, and anyway a default would not necessarily be to Treasury bondholders: many other payments, even to pensioners, could be sacrificed first. Though discussions have only just begun at Blair House, a stately building for official guests directly opposite the White House, both sides seem ready to lay out targets over the next decade that lower the deficit from 10% of GDP this year to 3% or less in 2015. That figure would represent a "primary" balance (a balanced budget once interest payments are excluded), and would also arrest the rise in the debt as a share of GDP. Furthermore, both sides appear to agree that if those targets are about to be breached, "triggers" would automatically cut spending or raise taxes across the board.

Although everything is officially on the table, the two parties have put to one side the most divisive issues: taxes and entitlements. In particular Medicare, the health-care programme for the elderly that is the single biggest contributor to the long-term deficit, will be excluded from wholesale reform. Republicans have passed a budget that would replace traditional Medicare with vouchers. But David Camp, the Republican who heads Medicare's oversight committee in the House, said on May 5th that he would not waste time on something the Democrat-controlled Senate would never pass. Administration officials would make minor trims to Medicare, but only if Republicans accept at least token tax increases.

That still leaves plenty to quarrel over. With big entitlements off the table, the spending cuts Mr Boehner wants would have to come from discretionary spending, which includes defence, or smaller entitlements such as food stamps, federal-employee retirement benefits and farm subsidies. (Discretionary spending has to be authorised each year; entitlements do not.) Andy Laperriere of ISI Group, a brokerage, reckons the two sides can come up with $1 trillion in such cuts, well short of the $4 trillion or more over the next decade or so that both sides originally wanted.

A deficit agreement that leaves out taxes and the biggest spending programmes hardly represents great courage; but an agreement on targets would be progress compared with December, when neither party had a serious medium-term deficit plan. Officials in both parties protest that they cannot be expected, in two months, to bridge an ideological canyon that has developed over 40 years. Better to advance their competing visions now and ask voters to choose in the election of 2012. At that point they will be forced to act, to avoid the brutality of the triggers.

Trigger happy

Year	Trigger	Outcome
1984	Reagan proposed income tax surcharge and oil tax if deficit exceeded targets	Never enacted
1985	Gramm-Rudman-Hollings automatically triggered discretionary spending cuts if deficit exceeded target	Mostly circumvented
1990	Budget Enforcement Act capped discretionary spending and required offsets for tax cuts and new entitlements	Adhered to until surpluses appeared in 1998
1993	Clinton set entitlement caps that, if exceeded, required him to propose spending or tax remedies	Never needed
1997	Medicare "Sustainable Growth Rate" mandated cuts in physician fees if costs grew too quickly	Overridden every year since 2003
2003	A "Medicare funding warning" required the president to propose changes	Ignored or circumvented
2010	Independent Payment Advisory Board set up to recommend changes if Medicare spending grows too fast	Takes effect in 2014

Sources: CBO; CRS; Government Accountability Office; Pew Charitable Trusts; Kaiser Family Foundation

Or so the theory goes. Triggers have a mixed record (see table and our economics focus this week). The most successful was the Budget Enforcement Act of 1990, which capped discretionary spending growth and required new entitlements or tax cuts to be paid for. It succeeded because both parties had already agreed both to cut spending and to raise taxes to get the deficit down; the triggers merely guarded against backsliding.

Triggers fare less well when the hard decisions have yet to be made. The 1985 Gramm-Rudman-Hollings Act imposed automatic spending cuts or "sequesters" to drive down the deficit. Congress repeatedly circumvented the triggers by shifting some items from one year to the next, classifying others, such as carrying out the census, as exempt emergency spending, and ultimately by overriding the law altogether. Medicare already has three triggers. Two of them have long been routinely overridden or ignored. The third, which empowers an independent panel to propose treatment changes, will not take effect until 2014, and Republicans are bent on repealing it before then. The lesson, says Susan Irving of the Government Accountability Office, a non-partisan arm of Congress, is that "no process change can force agreement where one does not exist."

That bodes ill for the present. Both sides in principle favour the use of triggers, but are far apart on how they would work. Republicans want taxes left out; Democrats plausibly argue that this would sap their incentive to negotiate, since in an impasse they can let the triggers accomplish only what they want. Hammering out the details of the triggers, in other words, could be as hard as agreeing to the spending and tax changes themselves. Meanwhile, a separate group of six senators is struggling to produce its own, bipartisan, agreement on deficit reduction; one of the six has resorted to publishing his own plan to cut the deficit through equal measures of spending cuts and tax increases.

The action has now shifted to Blair House, where Joe Biden, the vice-president, presides over a panel of two Republicans and four Democrats, plus a battery of advisers. The tone in the two days of meetings is said to have been more constructive and less extreme than the public rhetoric, with neither side drawing lines in the sand. But White House officials worry that they could strike a deal one day only to have Republican negotiators, pressured by their more extreme colleagues, revise their demands the next. It has happened before.

Mr Boehner is probably more flexible than he lets on, but he neutralises criticism from tea-partiers by talking tough and making concessions only at the eleventh hour. Republicans have done well through such brinkmanship. They were prepared to let everyone's taxes soar in January rather than let them rise only on the rich, and to let the government close down in April to extract bigger cuts in this year's budget. Mr Obama may have to agree to a spending-only trigger, and hope that cuts to veterans' benefits and defence will be as intolerable to Republicans as tax increases.

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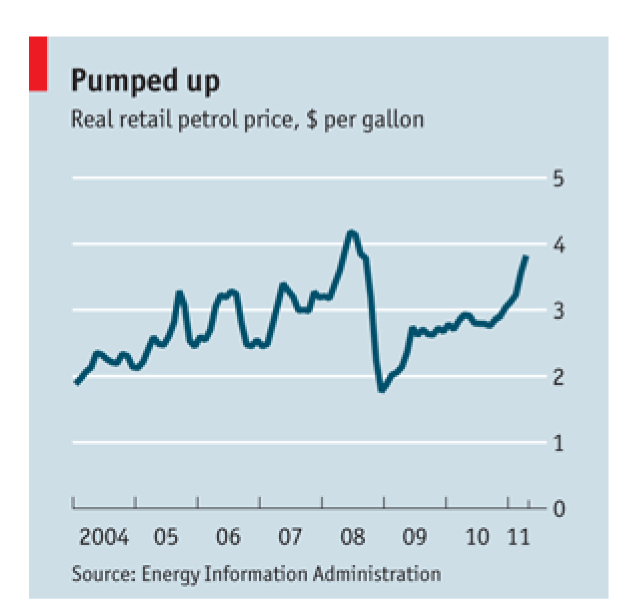
The politics of the pump

A rhetorical blowout

America's politicians cannot control the price of petrol-but they still try

THE last time the price of petrol (gasoline) was at its current level, Barack Obama observed in March, "you had all kinds of slogans and gimmicks and outraged politicians...The truth is, none of these gimmicks, none of these slogans made a bit of difference." Yet as the petrol price again nears the fearsome threshold of $4 a gallon, America's politicians, including Mr Obama, are at it again, resorting to exactly the same sort of theatrics, with equally meagre results.

The reflex is understandable. According to this week's *Economist*/YouGov poll, 80% of Americans consider the increase in the price of petrol a very or somewhat serious problem. Fully 68% claimed to be driving less as a result; 43% said they were cutting back on other spending to pay for petrol. Some pundits reckon the re-election prospects of Mr Obama and many members of Congress hinge on the pump price, as much or more than they do on the unemployment rate. Mr Obama himself implied as much at a recent fund-raising dinner in California, when he said that rising prices were weighing down his approval rating.



No wonder, then, that the Republicans who run the House of Representatives have dusted off one of the slogans the president was complaining about: "Drill, baby, drill". They claim, quite inaccurately, that the dollar-a-gallon rise in prices over the past year is somehow a result of the administration's caution in approving drilling permits and opening new territory for exploration following the massive oil spill in the Gulf of Mexico last year. (The real culprits are the strong global growth rate and turmoil in the Middle East.) In an attempt to force the president's hand, the House has passed a series of bills setting an accelerated timetable for new lease sales and speeding up the process of applying for drilling permits.

It is true, although hardly surprising, that the government is issuing permits to drill in deep water at a much slower pace than before the spill. It is also true that there is significant scope to expand America's output of oil and natural gas: by the equivalent of 4m barrels of oil a day-roughly a fifth-by 2025, according to a study commissioned by the American Petroleum Institute, a lobby group. But America's oil output is already growing, for the first time in decades, despite Mr Obama's supposedly ruinous policies. Moreover, as API's study suggests, it will take a decade or more of exploration and development to bring new offshore basins into production. Anyway, as Mr Obama keeps pointing out, even in the rosiest of scenarios, America will still be consuming far more oil than it produces (it currently produces 8m a day and uses 18m). Drilling, in short, is neither an immediate nor an adequate cure for America's addiction to oil.

But the Democrats' preferred remedies are even less effective. They propose stripping oil firms of various tax breaks-something that could not possibly lower the price of petrol, but might make angry motorists feel better nonetheless. Happily, the changes they have in mind are too inconsequential to deter much investment either, given the high price of oil, although they could dent spending on natural gas. Mr Obama, meanwhile, has set his sights on speculators, a habitual if elusive scapegoat, creating a special new task-force to hunt them down.

Yet as Paul Bledsoe of the Bipartisan Policy Centre, a think-tank, points out, the most effective step to protect Americans from rising petrol prices has already been taken. In 2007, as the oil price climbed towards its previous peak, Congress agreed to raise fuel-efficiency standards for cars for the first time in a generation. Last year the Obama administration

tightened them further. By 2016 cars made in America should average 39 miles to the gallon, compared with 27.5 last year. That will save 1.8 billion barrels of oil, the government calculates, over the lifetime of the vehicles sold between now and then.

In September the administration will propose fuel-efficiency standards for the nine years from 2017. It is debating whether they should increase by 3% or 6% a year, which would translate into an average rating of 47 or 62 miles to the gallon by 2025. Mr Obama tends to talk more about flashier schemes to reduce America's oil imports, from promoting electric and natural-gas-fuelled cars to developing high-tech new biofuels. But, mundane as it sounds, the best hope for America's irate drivers is more of the same.

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Shale gas extraction

The need to be seen to be clean

Natural-gas production is booming, but its green image is in question



DRILL rigs tower over the silos on farms in Pennsylvania. Once-empty mesas in western Colorado, where mule deer and sage grouse ranged freely, now look like a neural network from a bird's-eye view, with well-pads connected by dirt roads scattered across the landscape.

These are the signs of America's natural-gas boom. Thanks to new drilling technology, and in particular a controversial process called hydraulic fracturing or "fracking," the size of the proven reserves is growing. At the end of 2009 the United States had estimated reserves of 283.9 trillion cubic feet (8 trillion cubic metres) of natural gas, up 11% from the year before. In 2010 the country produced 22.6 trillion cubic feet of natural gas, up from 18.9 trillion cubic feet in 2005. The price at the wellhead has dropped from $7.33 per thousand cubic feet to $4.16 during the same period.

Natural gas is cheap and plentiful. That makes it an appealing alternative to wind and solar power, which are relatively expensive and erratic. And plants powered by gas emit far less carbon dioxide than those powered by dirty coal. Nearly half of America's electricity is generated by coal, and electricity generation accounts for 40% of America's carbon-dioxide emissions. In 2009, the most recent year for which data are available, the country's greenhouse-gas emissions were at their lowest level since 1995. That was partly due to the bad economy, and partly to the increased use of renewables and natural gas.

But some question whether natural gas is really as green as all that. For one thing, fracking uses a tremendous amount of water, a severely undervalued resource inland. And the process gives off methane, a potent heat-trapper. A study led by Robert Howarth of Cornell University found that greenhouse-gas emissions over the life cycle of natural-gas production could actually be considerably higher than those of coal per unit of energy provided. Greater care about methane venting would, of course, reduce that problem.

And fracking raises other concerns. In the process, a mix of sand, water and chemicals is pumped deep underground at ferocious pressure. That breaks up shale formations, releasing the gas trapped inside so it can be pumped to the surface. But fracking is almost entirely unregulated, because of a 2005 statutory exemption from the Safe Drinking Water Act. Three members of Congress recently released a report on fracking, saying that oil and gas companies used more than 2,500 fracking products containing 750 chemicals between 2005 and 2009. Some ingredients were benign, such as citric acid and instant coffee. Others, though, were extremely toxic, such as benzene and lead. Only five states require public disclosure of the chemicals used, and only to limited and varying degrees. That is making landowners, locals and environmentalists edgy, particularly in big production states like Colorado, Pennsylvania, and Texas, the nation's largest natural-gas producer, where an enormous reserve-the Barnett Shale-sits under a big city, Fort Worth.

The chief fear is that the mystery slurry could get into the water supply. In some fracking towns, people have been able to set their tap water on fire. And there have been troubling safety incidents. In late April a big company, Chesapeake Energy, suspended its fracking in Pennsylvania after one of its natural-gas wells blew out and spilled toxic drilling fluid into a nearby creek. France has placed a moratorium on fracking and is close to a full ban.

Activists and scientists reckon that if the process is safe, the companies should come clean. "If they've got nothing to hide, why is the industry so paranoid about disclosing their chemicals?" asks Steve Torbit, executive director of the National Wildlife Federation's Rocky Mountain region. They may have to. The Environmental Protection Agency is studying the process. In 2009, House Democrats proposed legislation that would force the industry to disclose the chemicals it uses in fracking. Several states, including Texas and Colorado, have similar legislation pending.

In the meantime public concerns are growing. Late last month 200 people packed a Bureau of Land Management hearing in Golden, Colorado. Dave Cesark, an executive at Mesa Energy Partners LLC, tried to reassure, saying that fracking chemicals constitute "just a drop in the bucket": only 0.5% of the total fluids, including water, that the company uses to drill natural gas. The crowd did not, strangely enough, find that entirely reassuring. Some producers will grumble that any regulation of fracking is an unwarranted constraint on their business. But if natural gas is not produced cleanly, it will not prove to be so cheap, either. Full disclosure is a price worth paying.

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New York's old people rebel

To the barricades for Medicare

A by-election may be a referendum on the Republicans' health plans



NEW YORK is a blue state. Its governor, Andrew Cuomo, is a Democrat, as are its two senators. But chunks of it are very conservative, such as the reliably Republican 26th congressional district in western New York. It spans the suburbs of Buffalo, across hundreds of acres of farmland, to the suburbs of Rochester. Registered Republicans outnumber registered Democrats there by around 30,000. George Bush handily won the district in 2004, though he lost the state by 19 points. In 2008 it was one of only four New York districts that voted for John McCain over Barack Obama. Chris Lee, the Republican who had represented the district since 2008, won a whopping 74% of the vote at the 2010 mid-term election. He stepped down in February after a gossip website posted shirtless pictures he had sent to a woman he had met on Craigslist.

The special election (as Americans call a by-election) to fill the Craigslist congressman's empty seat will take place on May 24th. Jane Corwin, a wealthy conservative member of the state Assembly, should on past form be a shoo-in, but recent polls indicate she has an unexpected battle on her hands. According to one recent poll Kathy Hochul, a Democrat, is just a few points behind Ms Corwin, and another shows her in the lead. Jack Davis, the self-financed independent "tea-party" candidate, is also performing solidly in the polls. At first glance it appears that Mr Davis, a former Republican who also ran (unsuccessfully) for office as a Democrat, may be siphoning support away from Ms Corwin.

But the fall in Ms Corwin's support could be more because of her endorsement of Paul Ryan's proposal to replace Medicare, the public health-care scheme for the elderly, with diminishing government subsidies for private insurance. Her opponent, Ms Hochul, has made Medicare the main issue of her campaign. "We can alter the national debate with one election," she says. Voting for her, she claims, would send a message to Republicans in Washington. She has received the backing of the National Committee to Preserve Social Security and Medicare, which previously campaigned for the Republican who represented the area until 2008. Her message is going down well in the district, where almost a quarter of voters are over 65 and almost two-thirds are over 45.

A loss in the 26th would be a huge embarrassment for the Republicans, suggesting that many other seats might be at risk in 2012. So the party has been pumping money into the race, and has also started to send in the heavy artillery. Eric Cantor, the House majority leader, campaigned for Ms Corwin last week, and John Boehner, the speaker of the House, appeared at a Corwin fund-raising lunch on May 9th. He said there that the "Democrats are hoping they can steal this election so they can continue to move their agenda, which is more taxes and higher spending." This got loud jeers from the faithful, but it remains to be seen whether ordinary elderly voters will agree.

The turnout tends to be low in special elections, as elsewhere; but politicians can usually depend on older voters to make the effort. In the 26th district, the voting intentions of the elderly have never been more important.

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The Republican nomination

The dance of the seven tweets

The former speaker starts a presidential campaign

NEWT GINGRICH entered the race for president much as he has conducted himself throughout his political career: chaotically. In March his aides let slip that he would make a big announcement during a stop at the state capitol in Atlanta, Georgia, only to retract the whole plan for reasons that still remain opaque. Then on May 9th his staff used Twitter to declare that two days later he would issue a tweet, along with an update to his Facebook page, that would mark his entry into the race. All this tweeting about possible future tweets kept commentators puzzling (which may have been part of the point) but finally, on May 11th, the immortal words "Today I am announcing my candidacy for President of the United States" appeared on Mr Gingrich's feed, in between a plug for an upcoming television appearance and an enthusiastic mention of a book about the Berlin wall.

Mr Gingrich's affinity for social media notwithstanding, most Americans think of him as a figure from the past. He was first elected to Congress in 1978. In 1994 he was the inspiration behind the Contract with America, a manifesto that helped the Republicans to win a majority in the House of Representatives for the first time in 40 years. As a result, he became speaker, and proceeded to duel with Bill Clinton, the president of the day, over both budgets and Mr Clinton's personal life.

All this means Mr Gingrich is not only known to Republican primary voters, but is something of a hero to many of them. But he is a flawed one, in several respects. For one thing, he is generally considered to have come off worse in his battles with Mr Clinton, who romped to re-election after the government shutdown of 1995-96. Mr Clinton also survived the Republicans' subsequent attempt to impeach him, while the Republicans lost seats in the House at the next election. Mr Gingrich took the blame for the party's poor showing, and resigned. He has not held public office of any sort since 1998.

Worse, from the prospective of many Republicans, Mr Gingrich turned out to have just as louche a personal life as Mr Clinton. He has been married three times, having had affairs with his second and third wives while still married to their predecessors. And then there is that mercurial temperament. Since he began publicly contemplating a presidential run last year, he has likened those wanting to build a mosque near Ground Zero to Nazis, blamed his affairs on his patriotism (which led him to work so hard, he explained, that he lost his moral compass), snapped at an audience member at a public event who asked him about his private life, flip-flopped on the wisdom of America's involvement in Libya and then refused to admit that he had done so, despite being caught on camera.

All this helps to explain why Mr Gingrich is polling rather limply, despite his high name-recognition. Nonetheless, he is not without strengths. He should hold some appeal for Republicans of all stripes, from fiscal hawks to evangelicals (since converting to Catholicism in 2009, he has been complaining that America has become too secular). He is a prolific fund-raiser, and has created a network of activists over the years that will enthusiastically promote his cause. He fizzes with energy and ideas, and seems more of an intellectual heavyweight than most of the current field (though that is not hard). Whether Mr Gingrich turns that into an asset, by appearing grave, informed and presidential, or a liability, by thinking aloud and going off on tangents, is still an open question-though we rather suspect the latter.

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Health-care reform

The American exception

Vermont may become the first state to have government-run health care



THE wintry state of Vermont is no bellwether. Last year Republicans across America declared the evils of "Obamacare", a tactic that helped them seize six governorships, six seats in the Senate and 63 in the House. In Vermont Peter Shumlin, the Democratic candidate for governor, insisted that Barack Obama's reforms had not gone far enough. "Vermont needs a single-payer system," he told voters. "Get insurance companies out of the picture." Mr Shumlin won the election. Now he is preparing to fulfil his promise.

On May 5th Vermont's legislature passed a bill that lays out steps to adopt a single-payer health system. Mr Shumlin is expected to sign the bill shortly. No state is likely to follow Vermont's lead, at least in the near future. But with Vermont, America begins its first experiment with government-run health care.

Vermont is an appropriate setting for the test. It is the state that re-elects Bernie Sanders, the self-described socialist senator who in 2009 presented a 700-page single-payer amendment. For local politicians, reforming health care is something of a hobby. They have debated universal coverage for decades, notably in the 1990s. But they have also enacted other changes, such as a state-subsidised health plan and a requirement that insurers cover services for autistic children. Vermont's Medicaid programme is among America's most generous. As a result only 10% of Vermonters are uninsured, according to the Kaiser Family Foundation, compared with 17% of Americans. Health spending per person is 15% higher than the national average.

The new law attempts to expand coverage and lower costs. The state will move forward in two steps. The first goal is to create a health exchange by 2014, as required by the national health reform. The second is to use the infrastructure of that exchange, such as a single system for paying claims, to introduce publicly-funded health care in 2017. An independent board will set payment rates for doctors and hospitals, as well as benefit packages for patients. Costs will be contained, Mr Shumlin says, by cutting administrative expenses, slashing fraud and rewarding doctors for the quality rather than just the quantity of care.

However, this progress may not proceed as hoped. Single-payer systems are not a panacea-health spending is growing at a faster clip in Britain and Canada than in America. Furthermore, the main aspects of Vermont's plan have yet to be worked out. Most crucial, politicians have not decided how the scheme will be funded. In a study for the state legislature, William Hsiao of Harvard University recommended a payroll tax on companies and employees, rather than paying for it out of general taxation. But the governor's office has until 2013 to present a plan. It is also unclear which health services will be covered and how to pay for Vermonters who seek care out-of-state. And the whole scheme will need federal approval.

All this makes Betsy Bishop, president of Vermont's chamber of commerce, nervous. "Businesses are still concerned about the benefit package, the financing mechanism and how that all comes together for their employees," she explains. Anxious firms may be joined by other restive groups. Michael Cannon of the Cato Institute, a libertarian think-tank, predicts that efforts to limit care and cut payment rates will spark a revolt by doctors, hospitals and patients. Still, Vermonters are stubborn. They may yet defy cynics and become a successful model for single-payer care. But spreading the idea across America will be an awful lot harder.

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Concealed carry in Texas

Students v guns

Anger at bills to allow concealed weapons on campus

ON APRIL 4th an alert went out around the University of Texas at Austin. Police had received a report of an Asian male, apparently carrying two weapons, near the university's main gym. Half an hour later an update came: the subject had been located. He was a member of the military training corps, and the guns were replicas.

Phew. But that is the kind of situation that has gun opponents worried about a new bill working its way through the Texas legislature. The measure would allow people to carry concealed weapons on campus, as long as they have the proper licence. That is currently prohibited in about half of the states, including Texas, although Texas lets individual universities opt out of the prohibition if they have their hearts set on it. Measures to overturn blanket campus prohibitions have popped up in a number of states this year, including Michigan, Arizona, Nevada, and Tennessee.

This is, of course, contentious. Gun proponents argue that concealed weapons can make public places safer. They point to an incident from 2007, when a heavily armed gunman entered a Colorado church. He killed two people before one of the congregants, a former policewoman, managed to shoot him. Opponents respond that people with concealed weapons might accidentally make things worse in fraught (or just drunken) situations. At a hearing in Austin in March dozens of witnesses waited to testify, with high emotions on both sides. Students said that the idea frightened them. Those in favour spoke of the right to self-defence.

But the issue at hand in these bills is not concealed guns exactly. Most states give people the right to have them, although there are certain places, such as airports and primary schools, where the right is limited. The logic is that these spaces have special security concerns. But are university campuses not special too? Critics of the legislation reckon that they are, given the youth of the population, and the emotional tensions of the environment.

The critics have notched up some victories. On April 18th the governor of Arizona, Jan Brewer, vetoed that state's bill to allow "concealed carry" on campus. Earlier this month the Tennessee measure was shelved in committee. The Texas bill, after sailing through the House, seemed to stall in the state Senate. But on May 9th it made it through, after Republicans attached it to a bill intended to raise extra money for state universities. That bill passed and now goes back to the House. It is likely to pass, and then to be signed into law by the governor, Rick Perry. "I would argue that Texas is [already] a pretty gun-friendly state," said John Whitmire, a Democratic state senator from Houston, while chairing the March hearing. It looks like it.

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Lexington

Save the fourth amendment

Fear of crime, not just fear of terrorism, has nibbled away at America's liberties



IT IS only a mile or so from the colonnade of the Supreme Court to some of Washington, DC's most dangerous neighbourhoods. But these two parts of the nation's capital could be in different countries. On any given night, armed police prowl north-east Washington in search of guns or drugs. So routine are these patrols that black men sitting on stoops or standing on corners will reflexively lift their T-shirts when the police approach, to show that they have no pistol tucked into their waistbands. Often the police will frisk them anyway, and search their cars as well. You might almost forget, in light of these encounters, that the fourth amendment to the constitution establishes the right of the American people to be "secure in their persons, houses, papers, and effects, against unreasonable searches and seizures."

David Shipler, a former *New York Times* reporter and winner of the Pulitzer prize, does not want you to forget. In a new book ("The Rights of the People", Alfred Knopf) he argues that America's search for safety is relentlessly eroding the precious protections in the Bill of Rights. He decided to write the book-the first of a pair-on September 11th 2001, the day al-Qaeda struck the twin towers. After watching the awful images on television, he suddenly understood: "There go our civil liberties."

This column argued last week that the fears engendered by September 11th had made America a less trusting and innocent place, permanently on its guard against the danger of terrorism. An abiding symbol of this change is the prison camp at Guantanamo. A stash of 700 more WikiLeaks documents made public recently contains details of how and why people from all over the world were taken there and how they were treated. The overall picture, in the only slightly overwrought words of the *New York Times*, one of the newspapers that published the documents, is of a "legal and moral disaster". Innocent men were picked up on the basis of scant evidence and in many cases subjected to abuse and torture. One man-allegedly a terrorist, but a man nonetheless-was "leashed like a dog, sexually humiliated and forced to urinate on himself". His testimony was then used to incriminate others.

It is, however, not just the war on terror that has nibbled away at liberties. So, says Mr Shipler, have the fights against crime and illicit drugs. "In criminal justice, as in counter-terrorism," he notes, "the executive branch has grabbed immense authority, distorting the process of determining guilt or innocence."

Part of the damage is done by the habit of police everywhere to cut corners and stretch their prerogatives. But the Supreme Court has played a part, too. To take just one of Mr Shipler's examples, the police must still usually show "probable cause" if they want a warrant to search a house. But for street encounters in which there is even the slightest possibility of danger to life, the court has over time substituted the woollier "reasonable grounds" or "reasonable suspicion", thereby giving officers on the beat a latitude they are delighted to exploit. Most street pat-downs are never recorded, scrutinised by a prosecutor, challenged by a lawyer or adjudicated by a judge. Yet, says Mr Shipler, they weaken the fourth amendment and poison life on the street in a thousand poor neighbourhoods in America.

Not much has changed since the election of Barack Obama. In his inaugural speech, the new president said that America did not have to make a "false" choice between its safety and its ideals. But having promised to close Guantanamo within a year, he has put the closure on hold in the face of resistance from Congress and public opinion. He has also had to drop a plan to try Khalid Sheikh Mohammed, by his own confession one of the September 11th plotters, in a criminal court. This

trial was going to showcase America's system of justice. Now Mr Mohammed is to be tried in Guantanamo, by a military commission.

As in the war on terrorism, so in the war on crime: the sharp question is how much risk a society is willing to absorb in order to preserve liberty. Mr Shipler's conclusion is that America is increasingly prone to give the wrong answer. The premise underpinning its justice system is that it is far worse to convict wrongly than to fail to convict at all. But in its responses to drug-trafficking and organised crime that ideal has been severely weakened.

Complacency, fear and fashion

Since American politicians talk about liberty all the time, why are they so feeble in its defence? Part of the explanation is complacency: America is one of the world's freest countries-why worry about the bending of a rule here or there? Part is fear: contrary to what Mr Obama says, there is a choice to be made between safety and liberty, and in many minds safety wins. Part is fashion. There are some libertarians in American politics, but on the conservative wing of the Republican Party the liberty talk has come lately to dwell more on the alleged threat to economic freedom posed by Mr Obama's alleged taste for big government, and less on the sort of freedoms entrenched in the Bill of Rights. The second amendment, on the right to keep and bear arms, is treated as holy writ, but the fourth has somehow lost its sex appeal.

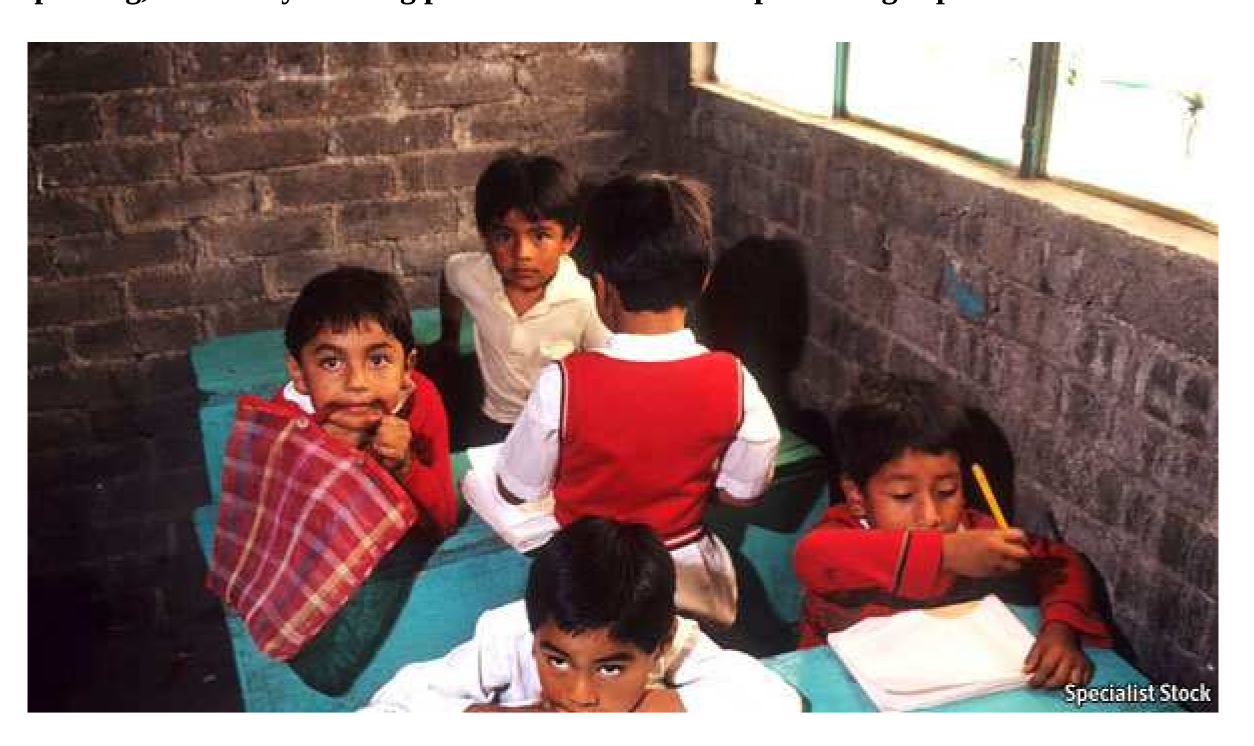
That is a pity. Mr Shipler used to report from the Soviet Union. He sees reminders of Soviet thinking in the United States since al-Qaeda's attacks. Though a bold line separates Soviet dictatorship and American democracy, people are much the same everywhere. That is why James Madison said two centuries ago that "all men having power ought to be distrusted to a certain degree". The lesson from the founders, Mr Shipler concludes, is that freedom depends not on the virtue of leaders or officials but on a "durable foundation of constitutional protections". The message from Guantanamo, and from the mean streets of north-east Washington, is that the foundation needs shoring up.

Economist.com/blogs/lexington

Education in Mexico

Schooling the whole family

Teaching is improving, but slowly. Getting parents involved could speed things up



WITHIN the bright-blue and green walls of Emilio Carranza, a three-classroom primary school in a rural part of the state of Puebla, a lesson is engrossed in a book of "Ecological Experiments and Facts". Hands shoot up with enthusiasm, undimmed even by a drill of singing the lengthy national and state anthems in the baking school yard. The school is an example of how Mexico has been using parents to help improve its education-long overdue in a country where high spending has failed to produce results to match.

By Latin American standards, Mexico's schools are rather good. According to the PISA survey, an international test of 15-year-olds in reading, maths and science, Mexico has the region's second-best educated children, after Chile. In maths it is improving faster than anywhere else in the 65-country study. The OECD says Mexico is "well on track" to meet maths and reading targets next year that Felipe Calderon set in 2007, near the start of his presidency.

Yet Mexico should be doing far better. Within the OECD, its education system ranks dead last. Whereas over a third of students in Singapore meet PISA's second-to-top maths grade, in Mexico less than 1% do. In maths it matches Thailand, a much poorer country. In science it is on a par with Jordan, poorer still. Although enrolment improved from 52% of 15-year-olds in 2000 to 66% in 2009, Brazil jumped from 53% to 80% in the same period.

Money is not the problem: education accounts for 22% of public non-capital spending, the highest share in the OECD (though well below the group's average in dollars per pupil). But 80% of non-capital education spending goes to teachers' salaries, well above the 64% OECD average. And many of Mexico's teachers are imaginary or dead. In 2008 an audit of one funding programme found irregularities in the records of 90,000 of its recipients. A teacher in Chihuahua was receiving 700,000 pesos (then $66,000) per month.

This mischief is tolerated thanks to Mexico's mighty teachers' union, which with 1.2m members is Latin America's biggest. Wielding those votes, its president, *"La Maestra"* ("The Teacher"), Elba Esther Gordillo, turns politicians into timid schoolboys. Mr Calderon's close victory in 2006 came with her support. His education reforms of 2008, which included competency tests for teachers, were watered down after strikes. Extraordinary perks remain: some teaching jobs are hereditary.

But the Emilio Carranza school's freshly painted walls, new lavatory doors and flower-beds show a way forward. They were installed by parents under a project called "School Management Support" (AGE), in which the parents' associations in some of Mexico's poorest schools receive grants of roughly $6 per student per year. The amounts are tiny, but a World Bank study suggests the impact is big. The bank doubled the grant in one group of schools, to $12. It saw dropout rates fall by over 1.5 percentage points and students move ahead by about a year in reading and maths. The gains are similar to those generated by the "Opportunities" programme, which gives poor families about $100 a month (although "Opportunities" has other benefits, including improved health.)

The success of AGE, reckons Harry Patrinos, a World Bank economist, comes from mobilising parents. The budget meetings mean that "parents feel committed. They're giving, not just receiving," says Monserrat Guzman Salamanca, the head teacher at Emilio Carranza. Parents have stepped in where the state cannot or will not help: on one classroom wall is a rota of fathers who guard the school day and night (a local nursery was recently robbed of everything from its Christmas tree to its bathroom soap). The budgeting process gives parents the opportunity and confidence to quiz teachers about their child's progress. Parent pressure has also lowered teachers' absenteeism.

Focusing on families could pay dividends. The main reason children drop out is not poor teaching but the need to work and, for girls, to marry, according to the Mexican Institute for Competitiveness (IMCO), a think-tank. Poor children would do better if their parents could help them more with their homework, it suggests. The OECD says that in Chile, the one Latin American country that outperforms Mexico, 24% of parents are educated to upper-secondary level, whereas in Mexico 16% are. After-school support, using mentoring and homework clubs, could also help.

Other initiatives are making it easier for parents to monitor schools' performance. ENLACE, an online database, shows exam results for every school in the country, with sample questions and answers. It marks "a real milestone in public accountability," says Andreas Schleicher, an OECD education guru. Phantom teachers are being tackled by Mexicanos Primero, an NGO, via an online campaign called "Where's my teacher?", in which students can report who is actually showing up.

Parents cannot solve all of Mexico's problems. The system is still highly centralised: efforts to give states more autonomy in the 1990s only decentralised the bureaucracy, Mr Schleicher says. The growth of *telesecundarias*, secondary schools in rural areas where students learn by television broadcasts, threatens Mexico's performance, thanks to their poor results. There is still no independent inspectorate. And teachers' career structure means that the weakest, most remote schools

often get the least-experienced teachers. Until politicians tackle these problems too, parents will have to push hard from below.

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Ecuador's constitutional referendum

A close count

The balance of powers hangs in the balance

LAST September Ecuador's police staged an ugly mutiny to protest against a cut in their benefits. During the uprising Rafael Correa, the president, was trapped for hours in a police hospital. Although there is no proven evidence that anyone involved sought to oust him, he has called the event an attempted coup. In an effort to shore up his power, he then scheduled a referendum to reform the constitution he inspired in 2008, following in the footsteps of Venezuela's Hugo Chavez. To rally support, he distributed sheep to indigenous farmers and raised salaries for the army and bureaucracy.

On May 7th Ecuadoreans voted on a 4,000-word package of ten amendments, phrased in impenetrable legalese, that would give Mr Correa broad new powers over the courts and media. That night the government's preferred pollster, Santiago Perez, released an exit poll showing that all ten questions had been approved. Mr Correa announced that the proposals had passed by an average margin of 7%, and celebrated with a song-and-dance routine.

The first official results showed a much closer vote. While the government led on most proposals, it trailed on two key amendments, which would reform the top judicial oversight body and create a regulatory council to ensure "responsible" media coverage. Counting then proceeded painfully slowly, with the National Electoral Council suspending the tally in many districts, citing administrative problems like missing ballots or signatures-leading the opposition to fear fraud. On May 11th, the yes side edged ahead on the two questions it had been losing. As *The Economist* went to press, the government still led those contests by a razor-thin margin, with 66% of the vote counted. The council has until May 17th to publish its results.

The outcome will further polarise Ecuador's politics, by emboldening both the president and the opposition. Mr Correa can point to the fact that he is far more popular than any of his recent predecessors, although his approval rating has declined this year. The amendments outlawing "unjustified" wealth, making it easier for prosecutors to hold criminal suspects without trial and requiring owners of banks and media to divest their holdings in other industries appear likely to pass-giving the president new power to put financial and legal pressure on his rivals.

The opposition, for its part, will either cry fraud if the late surge in the government's favour on the courts and media questions holds up, or tout their rejection if it does not. Either way, they are likely to step up their efforts to investigate corruption in Mr Correa's government. And in a closely divided legislature, they will also try to take over key committees to prevent Mr Correa from abusing the amendments.

The president is still far from absolute power. He does not control Congress, and is strapped for cash. But he has plenty of time to prepare for the 2013 election.

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Canada's environment

Boreal blues

In the frigid north tension grows between conservation and development

CANADA'S vast boreal zone contains the world's largest intact old-growth forest and has more fresh water than the Amazon. Its flora help to slow climate change and it is a breeding ground for 3 billion migratory songbirds. Only 12% of the region is now formally protected, well below the 50% scientists say is necessary to save its ecosystem. On May 9th Quebec unveiled the Plan Nord, a C$2.1 billion ($2.2 billion) proposal that seeks both to develop its northern region and to safeguard its environment. But whether those two objectives are actually compatible remains open for debate.



For a party closely tied to the oil industry, the Conservatives-who won a majority on May 2nd after five years of minority government-have been surprisingly progressive in protecting boreal land. They have set aside 12% of the area's 552m hectares (1.36 billion acres), including the Mealy Mountains national park in Labrador announced last year (see map). Some provinces have also taken the lead. In 2010 Ontario passed a law shielding half of its far north from development, and Manitoba recently protected 4m hectares of forest. Quebec's Plan Nord would ban industrial activity in half of its north and make 12% a nature reserve, and offers tax credits for eco-friendly projects.

Yet provincial governments are also pushing to tap the region's rich resources. Ontario has registered 30,000 mining claims in an area west of James Bay nicknamed the "Ring of Fire", where chromite (used for stainless steel) was found in 2006. And Quebec's Plan Nord will open an area twice as big as France to mining, energy development and forestry. Meanwhile Alberta has few limits on boreal oil exploration. In April its government released the details of a plan to protect 20% of the region's land and faced a backlash from energy firms. The federal government has little power to make the provinces become greener.

Aboriginal groups, who hold treaty rights in the north, have also tussled with environmentalists, whom they blame for disrupting their fur trade and seal hunt. They hope that miners will provide much-needed jobs. Ontario's Nishnawbe Aski Nation and the Quebec and Labrador arm of the Assembly of First Nations say they were not adequately consulted before their provinces' conservation laws were drafted, and now oppose the legislation. Indigenous peoples may not be as anti-green as oil companies, but they are no tree-huggers either.

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Pakistan after bin Laden

Humiliation of the military men

Civilian leaders and the United States put pressure on the beleaguered generals



AMERICA'S killing of Osama bin Laden on May 2nd brought with it a rare chance to ease the Pakistani army's unhealthy grip on the country's domestic and foreign affairs. The generals have floundered since the raid in Abbottabad, unsettled by accusations of complicity with bin Laden or, if not, then incompetence. It has not helped that video clips show bin Laden apparently active as al-Qaeda's leader in his last years.

Pakistanis cannot agree what is more shocking, that bin Laden had skulked in a military town so close to the capital, Islamabad, or that Americans nipped in to kill him without meeting the least resistance. Either way, they know to blame the humiliated men in uniform. Columnists and bloggers even call for army bosses to fall on their swagger sticks.

Ashfaq Kayani, the now sullen-faced head of the armed forces, and his more exposed underling, Ahmad Shuja Pasha, who runs the main military spy outfit, the Inter-Services Intelligence directorate (ISI), are unused to such cheek. Their spokesmen have fumbled to come up with a consistent line. They have claimed both that Pakistan abhorred America's attack and helped to bring it about. Army inaction on the night was because someone forgot to turn on the radar, or because it only worked pointing east at India. And General Pasha would, and then certainly would not, fly to America to smooth things over.

That disarray gave elected leaders a chance. Neither President Asif Zardari nor Yusuf Raza Gilani, the prime minister, deludes himself that he is really in charge. Nor do outsiders. Just after they had killed bin Laden, the Americans first telephoned General Kayani, not the president. In the past year both Generals Kayani and Pasha have had their spells in office extended beyond their usual terms, without a squeak from the brow-beaten civilians.

The armed forces scoop up roughly a quarter of all public spending and large dollops of aid, with no proper oversight, says Ayesha Siddiqa, a defence analyst. They also run big firms, employ over 500,000, grab prime land for retired officers, set foreign and counterterrorism policies and scotch peace overtures to India. They are racing to expand a nuclear arsenal beyond 100 warheads-Pakistan will soon be the world's fifth-biggest nuclear power and has been a chief proliferator.

Civilian silence thus spoke volumes. Rather than try to defend the army, both elected leaders found pressing needs to be out-of-town. Eventually, on May 9th, Mr Gilani did tell parliament of the army's fight against terrorists. He announced an inquiry into the bin Laden affair and said that, as ever, most problems were caused by America. Yet his careful vow of "full confidence in the high command" of the army and the ISI mostly emphasised their loss of prestige, as did a promise that on May 13th General Kayani would explain to parliament what had gone wrong.

The dismayed generals have sniped back. General Kayani told fellow officers that the civilian response had been "insufficient". Public figures with army links, notably Shah Mehmood Qureshi, a former foreign minister, and Imran Khan, a former cricketer and rising conservative politician, said the president and prime minister should quit.

Adding to the squeeze are the Americans. President Barack Obama talked again on May 8th of bin Laden's "support network" in Pakistan, a sign he has not yet ruled out ISI complicity. His officials sought (and reportedly got) access to

three of bin Laden's widows found in the Abbottabad compound. They also want to go back to the compound, to get back bits of a helicopter abandoned in the raid. Above all, they want the names of all the ISI men who worked on al-Qaeda.

Pakistani security men say it is ridiculous to suspect any complicity: they are at war with al-Qaeda, have arrested 40 of its leaders, and suffered violent attacks, including on ISI offices and the army's headquarters in Rawalpindi. But Americans point to a refusal to prepare a campaign against the Haqqani network, an al-Qaeda ally, in North Waziristan. They also note the ISI's longstanding ties to the Afghan Taliban, including its leader, Mullah Omar, who is assumed to be operating out of Quetta in Baluchistan. Perhaps American special forces will now go after him.

As it is, despite strenuous efforts by America's chief-of-staff, Admiral Mike Mullen, relations have been strained for ages. Ordinary Pakistanis have long resented American drone attacks on Afghan insurgents sheltering in their country. American and Pakistani spy agencies fell out last year as dozens of CIA men arrived without ISI oversight to hunt extremists in towns like Abbottabad. Relations only got worse in January, when police arrested a CIA contractor after he had shot two men dead in Lahore. The Americans remain bitter that normal diplomatic levers failed for weeks to free him.

The row rumbles on. This week some media, presumably fed by the ISI, outed the CIA station chief in Islamabad by giving his name. The same happened five months ago to his predecessor. On May 16th is another test, as a trial opens in Chicago of Tahawwur Rana, accused of helping a Pakistani terrorist group, Lashkar-e-Taiba, who struck Mumbai in November 2008. Among others indicted (though still at large) is a suspected ISI officer, "Major Iqbal", who is accused of helping to plan and fund the attacks which killed 170.

Generals Kayani and Pasha are struggling to calibrate their response. Both congratulated Marc Grossman, America's regional envoy, for bin Laden's killing when they met a few hours after the raid. In public, by contrast, General Kayani growled that America was trampling on Pakistan and must reduce its "footprint". Over military aid, they grumble that needed helicopters and fighter jets are held back. And to show that Pakistan has other options, Mr Gilani is to visit China, its "all-weather friend", on May 17th (see article).

Relations with America can only get so bad, however. General Mahmud Ali Durrani, ambassador to Washington until 2008, thinks the problem is that neither side speaks frankly. Rather than pretend that it will campaign in the wilds of North Waziristan, the Pakistani army should spell out how operationally hard that would be. And the Americans should set out the evidence for why they say the ISI collaborates with extremists.

Although the bin Laden raid has rocked the relationship, few predict a full break in ties. Not only will America need to get precious supplies to Afghanistan, mainly via the Pakistani port of Karachi, for years to come, but it is wary of isolating or destabilising a country with such a fast-growing nuclear arsenal. In turn Pakistan, with a decrepit economy, needs international aid. And it frets at signs of America falling in with its old rival, India. So the two sides are stuck with each other. As a former foreign minister says, America has concluded that Pakistanis are rascals, but at least they are "still our rascals".

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Pakistan and China

Sweet as can be?

Even an all-weather friendship has limits



Come rain or shine

PAKISTAN'S ambassador to Beijing, Masood Kahn, was this week fully armed with metaphors to describe the robust friendship between the two countries. "We say it is higher than the mountains, deeper than the oceans, stronger than steel, dearer than eyesight, sweeter than honey, and so on."

The relationship is indeed a geopolitical keystone for both countries. Pakistan serves as China's closest friend both in South Asia and among Islamic countries. So close, indeed, that many suspect China has asked Pakistan for the valuable remains of the American stealth helicopter abandoned during the bin Laden raid. Meanwhile, China can help counterbalance Pakistan's arch-rival, India, including in Afghanistan.

Pakistan seems keen to foster the impression that new tensions with America might nudge it even closer towards China. In his blustery speech to parliament on May 9th Prime Minister Yusuf Raza Gilani struck out on an odd tangent to praise China as an "all-weather friend", providing Pakistan with strength and inspiration. Not to be outdone, President Asif Zardari issued an effusive statement of his own about a friendship "not matched by any other relationship between two sovereign countries".

But if Islamabad is worried about falling out with Washington and hopes to get more out of Beijing, it may be in for disappointment. According to Zhu Feng of Peking University, such calculations based on "the traditional mentality of power politics" are misplaced. China's robust, longstanding ties with Pakistan stand on their own merits, he says, and owe nothing to America's standing in Pakistan. Both China and America want a stable Pakistan.

For all that, China's dealings with Pakistan have always been conducted with one eye on India. Last year Beijing chose to supply Pakistan with two new civilian nuclear reactors, even though the deal appeared to violate Chinese non-proliferation commitments. It was a boon not only for Pakistan's energy-starved economy. It was, as Mr Zhu points out, also a way for China to counterbalance a controversial nuclear deal reached earlier between America and India.

China and Pakistan have a lustily growing trade relationship, worth almost $9 billion last year. China provides military gear, including fighter jets and frigates. Some Chinese infrastructure projects in Pakistan have strategic implications. They include ports on the Arabian Sea and a proposed rail project which has yet to be approved, but which would arouse controversy, and Indian ire, by running through contested territory in Kashmir.

Still, China's commitment to Pakistan has its limits. After devastating floods last year, America gave Pakistan $690m, 28 of all international aid. China's contribution was a mere $18m. According to Andrew Small of the German Marshall Fund, an American policy institute, Pakistan may be "talking up the 'China option' beyond where the Chinese are willing to go." China, he reckons, will be reluctant to tilt too far towards what might look like an anti-India alliance". Despite border disagreements, China wants to keep its relations with India in reasonable order.

What is more, Pakistan's chronic instability and its failure, whether by design or incompetence, to suppress extremism make Pakistan as hard a partner for China to trust as for America. "Sweeter than honey" may be plenty sweet enough.

Hunger in North Korea

Let them eat maize husks

The politics of hunger in a brutal place



IT IS the time of year when the previous harvest has been nearly eaten and the next one has just been planted. Time, in other words, to worry about North Korea's perennially hungry masses.

North Korea had long grown dependent on food handouts from its estranged brother, South Korea, and from the United States. But the South's current president, Lee Myung-bak, has taken a tougher line, tying assistance to less provocative behaviour by Kim Jong Il's nuclear-tipped regime. So Mr Kim's envoys have travelled further afield of late, reportedly doing the rounds of Europe.

The UN's World Food Programme (WFP) is now preparing to distribute emergency aid to 3.5m North Koreans suffering from "severe malnutrition". Programme officials are concerned about the possibility of a famine on the scale of the one in the mid-1990s, in which over 1m died. They blame a series of shocks, including the coldest winter in years, widespread flooding and an outbreak of foot-and-mouth disease among livestock. Some 297,000 tonnes of cereal and 137,000 tonnes of fortified blended food must reach the most vulnerable.

With murky data, and diplomats and foreign-aid staff restricted in where they may travel, not everyone agrees with the WFP's assessment. Certainly, estimating North Korea's food needs has long been a politicised business. A member of South Korea's ruling Grand National Party, Yoon Sang-hyun, says that the North is hoarding 1m tonnes of rice, playing up a shortfall in order to get aid on the cheap. Some say Mr Kim wants the aid in order to announce a bumper harvest in 2012. That year is the 100th anniversary of North Korea's founder, Mr Kim's father, Kim Il Sung. Something approaching paradise has long been promised to North Koreans for 2012.

The South's unification minister, Hyun In-taek, also suspects North Korea of exaggerating its troubles for political gain. Certainly, he says, starvation has begun to overshadow other topics that the South would rather discuss, namely denuclearisation and the North's refusal to apologise for last year's shelling of Yeonpyeong island and the presumed sinking in March 2010 of a naval corvette. This is apparently a view shared by *Daily NK*, an activist network and news source which says that the price of rice in the black market has actually fallen by around half in recent months.

Others, such as Good Friends, a South Korean Buddhist charity long working in the North, insist the situation is very bad- and that tuberculosis is on the rise owing to malnutrition. *Rimjingang*, a magazine with reporters secretly stationed in North Korea, says that in North Pyongan province by the Chinese border even the army is going hungry.

Stephan Haggard and Marcus Noland, both at the Peterson Institute for International Economics in Washington, DC, say that even though the WFP has overstated the case, "all indicators point to a deteriorating food-security situation". What is more, they take issue with Mr Lee's belief that withholding aid will temper the North's behaviour. Rather, they argue, the response will merely be for the hermit kingdom to "hunker down and tighten repression". The regime has been consistent chiefly in showing complete disregard for its people.

But arguing is pointless. Widespread malnutrition and starvation in at least some parts of the country is a reality in North Korea. For Jimmy Carter, the former American president, who visited Pyongyang recently, the fault lies mainly with South Korea and the United States. That is presumably tonic to the real culprit for the hunger, the chubby Dear Leader, Kim Jong Il.

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Rethinking nuclear energy in Japan

Japan unplugged

Naoto Kan seeks to tap into the nation's energy-saving mood

FOR the past few years the zeitgeist in Japan has been about "grass-eating men", those young herbivores who eschew the salaryman's role of their fathers and prefer shopping to sex. Two months after nuclear disaster struck, the buzzword has become *setsuden*, or energy saving. With power in Tokyo in short supply, people take pride in walking up stairs from the underground because the escalators are off. Summer dress codes in government and other offices have begun a month early to save on air conditioning. Unusually for a Japanese politician, Naoto Kan, the embattled prime minister, has even caught the national mood.

On the back foot since the March 11th quake and tsunami, Mr Kan shocked the nuclear industry on May 6th when he called for the temporary closure of Hamaoka nuclear-power plant, an ageing facility on a tectonic fault line that would pose a tremendous risk for Tokyo if it suffered the same fate as the Fukushima Dai-ichi plant. After three days of prevarication, Chubu Electric, the plant's operator, reluctantly agreed to a shutdown.

The head of Japan's business lobby called Mr Kan's decision a piece of theatre that would harm industry nearby, including factories run by Honda and Toyota. Others considered it astute. The prime minister appeared to be rediscovering his roots in civic activism.

On May 10th Mr Kan shocked the nuclear tribe again by announcing his intention to rewrite from scratch a blueprint, scarcely a year old, that planned roughly to double nuclear power's contribution, accounting for half of Japan's energy mix by 2030. His remarks were unscripted and gave no indication he wanted nuclear energy to be abandoned altogether. Further, last year's plan was unfeasibly lofty. Still, in calling on Japan to focus more on renewable energy, the government has demoted nuclear energy as its priority, says Andrew DeWit of Tokyo's Rikkyo University.

It is unclear what will replace it, however. Thanks to post-earthquake shutdowns, the nuclear fleet is operating at just 44% of capacity. Brownouts this summer might weaken people's anti-nuclear zeal. Winning support for renewable energy will be hard after years of carpet bombing by the pro-nuclear lobby. It has even portrayed geothermal energy in this volcanic

land as a threat, since it might pollute the country's beloved *onsen*, or hot springs. But without renewables, Japan's carbon footprint looks set to grow.

Mr Kan is clear that nuclear power should remain a part of Japan's energy mix, but that it should be safer, better regulated and part of a more imaginative energy policy. For that, though, he must break the utilities' suffocating regional monopolies. So far, he has not sounded nearly bold enough for that.

Australia's finances

Tough love, or plain tough?

The government stakes its credibility on balancing the books

WITH its popularity falling since its election nine months ago, Australia's minority Labor government has staked its economic credibility on a promise to return the budget to surplus by 2013, when it is due to face voters again. But the budget for 2011-12 that Wayne Swan, the treasurer, presented on May 10th revealed just how tough that job will be.

Thanks mainly to one of the biggest resources booms in its history, Australia survived the global downturn better than other rich countries. The Australian dollar has soared in value; the terms of trade are the most favourable in 140 years. But the boom has been a mixed blessing for Australians outside the big mining states of Western Australia and Queensland that are feeding China's demand for iron ore and coal.

Manufacturers are finding it harder to export. Some are still carrying losses from the financial crisis. Mining companies, meanwhile, are writing off some big profits against investing to dig for even more: mining investment in 2011-12 is expected to reach a record A$76 billion ($81 billion). All this has helped to cut government revenues by A$16 billion below forecasts made late last year. Mending damage from Australia's floods and cyclones early this year has cost another A$8 billion. And so the deficit for the current fiscal year has blown out to almost A$50 billion, about A$8 billion more than forecast. A smaller deficit is expected for 2011-12. Then, says Mr Swan, a surplus of A$3.5 billion will appear in 2012-13.

Savings of A$22 billion, most in spending cuts, are the price. They will be more "tough love" than "tough", as ministers spin it. Unemployment, at only 4.9%, is forecast to keep falling next year. Yet Julia Gillard, the prime minister, reckons Australia still has "people who can work who do not". The government will tighten welfare for single parents, some disabled people and others, all designed to nudge them into jobs. Mr Swan puts a kinder light on it: as the economy grows, more Australians should be reaping rewards from the "Asian century".

Even the rich will lose some perks doled out from surpluses under the former conservative government. Meanwhile, this government will spend on more things. Some A$2 billion will go towards mental-health problems, which are thought to affect nearly a third of Australians at some point. And about A$300m will fund the "Malaysia solution", a plan Ms Gillard unveiled three days before the budget, aimed at deterring asylum-seekers arriving in Australia by boat. Australia will send 800 boat people to Malaysia for processing, and take back 4,000 people already assessed there as refugees.

Such a measure poses political risks. Broadly, though, economists have welcomed the budget's spending constraints. The central bank has warned lately that inflationary pressures from the resources boom could trigger rises in interest rates. Saul Eslake of the Grattan Institute, a think-tank, reckons the government has a bigger task than just balancing the books. It must not, he says, repeat the history of the three Australian booms of the past 60 years, each of which ended in runaway inflation and recession.

Bloody business

Rare in this part of the world, an outside body is allowed to peer in



Most soon came back

LONG-AWAITED, an international report into ethnic clashes that rocked southern Kyrgyzstan last June has not been well received. The independent Kyrgyz Inquiry Commission (KIC) was tasked with investigating bloodshed between ethnic Kyrgyz and Uzbeks in which around 470 died. The government agrees with some findings but strongly disagrees with others. Whereas ethnic Kyrgyz accuse the report of one-sidedness, ethnic Uzbeks-who accounted for three-quarters of the casualties and nine-tenths of the property losses-object to the commission's conclusion that the killing did not qualify as genocide.

For all that, Kyrgyzstan now stands out among former Soviet republics for allowing an outside commission to investigate the circumstances of bloody events, to determine responsibilities and to make recommendations. Other governments have flatly rejected calls for similar investigations-for example, after the government's shooting of hundreds of people in Uzbekistan's Ferghana Valley in 2005.

The seven-member KIC, a Nordic initiative accepted by Kyrgyzstan's president, Roza Otunbayeva, found that some military people were at the least complicit, and at the worst took part, in the events. "Had those troops been properly instructed and deployed, it would have been possible to prevent or stop the violence," the report said. More than 110,000 people fled to neighbouring Uzbekistan, from where most have returned. Some 300,000 stayed in the country but abandoned their homes.

In southern Kyrgyzstan the commission identified a power vacuum, fragile state institutions and weak rule of law in the wake of a national revolution that overthrew the previous president in April 2010, to replace him with a provisional government. It also underlined growing ethnic chauvinism in the politics of Kyrgyzstan, where ethnic Kyrgyz make up almost 70% of the 5.5m population. Uzbeks, less than 15% of the population, live mainly in the south and are under-represented in public life.

The Kyrgyz government says that it was hardly to blame. The ethnic violence flared up at a difficult moment, as supporters of the former regime were trying to regain power. The provisional government lacked political, financial and police resources. Even so, it retorts, it managed to put an end to the violence without outside help.

Banyan

Low expectations

In Singapore winning 7% of parliamentary seats is tantamount to an opposition triumph



THE People's Action Party, or PAP, has enjoyed almost untrammeled dominance of politics in Singapore for half a century. Last month, as the country geared up for an election, the PAP's Lee Hsien Loong, Singapore's prime minister, revealed that the party had given hard thought to whether one-party rule was entirely a good thing. Yes, it had concluded. Singapore lacked the talent to produce the two "A" teams needed in a two-party system. However, the PAP had taken the idea so seriously it had even contemplated splitting itself in two-only to reject the idea.

As it turned out, on May 7th Singapore's voters decided they did not need an opposition chosen for them. They elected one of their own. It is still tiny, holding just six out of 87 contested parliamentary seats. But this was the PAP's worst result since separation from Malaysia in 1965. The most seats it had ever lost before was four, in 1991. The PAP won 60.1% of the overall vote, down from 66.6% in the previous election in 2006, and 75.3% in 2001.

The PAP has learnt that two-fifths of Singaporean voters are disgruntled with it, despite Singapore's successes as a city that is rich, clean, law-abiding and pleasant, with a still-booming economy. A common perception is that PAP ministers, who pay themselves handsomely, have lost touch with the concerns of the less well-off-about rising prices, especially of housing, and about the rapid influx of immigrants, notably from China. Of the population of just over 5m, about a quarter are immigrants.

Politicians from the PAP can also come across as smug, arrogant and high-handed. In the past, voters have been deterred from electing non-PAP candidates by threats of discrimination against opposition-held constituencies in upgrading public housing. And it was never easy to find good candidates to run against the PAP. Anybody who had done well under its rule might be deterred by the fate of some opposition politicians in the past-variously ridiculed, sued for defamation, exposed in their peccadillos, disbarred from legal practice, bankrupted, or in exile.

Yet, besides the PAP, six small parties contested this poll. The electoral system is tilted against them. In 1988 Singapore introduced "Group Representation Constituencies" (GRCs), into which some single-member constituencies were merged. The enlarged areas are contested by slates of candidates, elected as a block. This is supposedly to ensure some MPs are from ethnic minorities, which must be represented on the slate.

But GRCs also make it hard for small parties to find the resources or strong enough candidates to compete. In this election, all but 12 of the seats were subsumed by four-, five- or six-member GRCs. The opposition had never won a GRC, and usually contested fewer than half the seats. This time it co-ordinated and fielded candidates in all but one constituency, a GRC where the PAP slate was led by Singapore's founding prime minister, Lee Kuan Yew, father of Lee Hsien Loong. Moreover, two veteran opposition MPs, including Low Thia Khiang of the Workers' Party, took risks by abandoning single-member seats to contest GRCs.

In the past, compulsory voting, warnings of a "freak" result (the opposition might win!), hardball politics and the exposure of the failings of some opposition candidates have been enough to ensure huge government landslides without electoral fraud or physical intimidation. At first, the short, nine-day campaign seemed to follow scripts from these previous quinquennial poundings of the opposition. The elder Mr Lee, now 87, warned voters in Mr Low's target GRC, Aljunied, that they would have five years to "repent" if they voted him in. The PAP asked why one impressive Workers' Party candidate had spent so long outside Singapore. A PAP minister drew attention to a video showing an opposing candidate taking part in a discussion on gay rights. His sexuality, said the minister, was his own business, but voters should know whether his party would pursue the "gay agenda" (male homosexual acts are illegal in Singapore). But the *New Paper*, a tabloid, splashed on its front page: "Is S'pore ready for a Gay MP?" Social-networking sites filled up with the rebukes of Singaporeans disgusted at the PAP tactic.

Under the ferociously modern PAP, Singapore has become one of the world's most wired societies, and the new media transformed the election campaign. They offered the opposition an unfiltered channel to reach voters. Even the docile mainstream media were forced to devote more coverage to the opposition, lest readers forsake them. Opposition campaign rallies were raucous and well-attended, especially in Aljunied. Mr Low's gamble paid off. He and the Workers' Party triumphed, both in his former seat and in Aljunied constituency, where they toppled Singapore's foreign minister, George Yeo.

Loyalty bonus

Mr Yeo and his slate aside, both opposition and government can claim some sort of satisfaction from the election result, as can voters. Singaporeans seem still to trust the PAP to do an efficient job, and mostly want not an alternative government but a stronger opposition. They have got one. They also seem to want a humbler government, and the prime minister is offering that too. Not only, during the campaign, did he actually apologise for some missteps. In acknowledging the landslide victory he also promised some PAP "soul-searching".

Lasting change, however, is not inevitable for a phenomenally successful party used to seeing opposition as at best a tiresome distraction and at worst a dangerous threat. The elder Mr Lee, for one, the government's "Minister Mentor", still seems to have doubts about the concept of a loyal opposition. "You believe the Workers' Party is in parliament to help the good of Singaporeans or to oppose the PAP?" he asked after the result. Incredible as it may seem to Mr Lee, many voters seem to think it can do both.

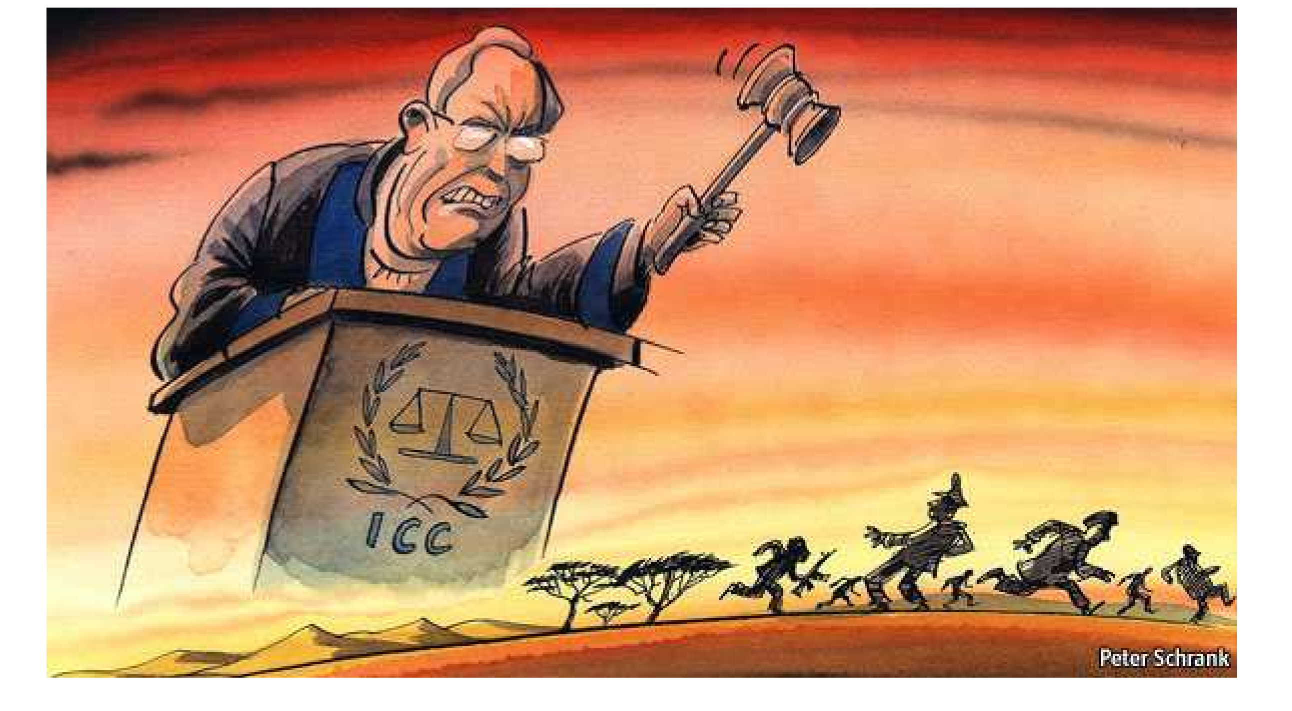
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International justice in Africa

The International Criminal Court bares its teeth

Many Africans resent the ICC, but recent events suggest that they may now be less able to ignore it



THE International Criminal Court in The Hague is about to open a formal investigation into post-election violence in Cote d'Ivoire at the request of the country's new president, Alassane Ouattara. This could lead to the indictment of Laurent Gbagbo, his despotic predecessor, whose refusal to cede power after losing an election led to hundreds of deaths. In Libya Colonel Muammar Qaddafi, Africa's longest-serving leader, is wondering whether he may face the same fate, after the ICC's chief prosecutor announced that he was seeking three arrest warrants (with names so far undisclosed) for those deemed most responsible for the killing of hundreds of unarmed people since pro-democracy protests began in February. Egypt's post-revolution regime says it wants to sign up to the ICC, the world's first permanent war-crimes court, perhaps in the hope of seeing its own fallen despot, Hosni Mubarak, brought to justice. The new Tunisia is also eager to join the court. In The Hague a verdict is expected within months at the trial of Charles Taylor, Liberia's former president, before a special court dealing with Sierra Leone. In Sudan President Omar al-Bashir is still wary of falling into the ICC's net, three years after being charged with genocide in his country's western province of Darfur.

African despots, past and present, several of whom have happily cocked a snook at the court, may be viewing it more nervously. Their countries' refusal to sign up to the ICC, set up in 2002, does not put them beyond its reach. The court's statutes let it prosecute people for suspected genocide, crimes against humanity and war crimes committed in any member state when that state is "unwilling or unable" to do so. Hitherto, this has usually been done at the request of the state itself, as in Uganda, the Central African Republic (CAR) and Congo. But it can also investigate atrocities in non-member states at the request of the UN Security Council, if deemed to threaten regional or international peace and security. This is what happened with Darfur, where the Security Council first drew the court's attention to the atrocities. Now the council has also referred Libya to the court.

This has been a tricky route. Three of the Security Council's five permanent members-America, Russia and China-did not sign up to the ICC. A threatened veto by just one of them is enough to block a mooted referral. But with Darfur, international alarm over the spreading rape and bloodshed persuaded America and China to abstain rather than oppose Sudan's referral in 2005. Since then the UN Security Council has sent only one other such case to the court. But the court's boosters have taken heart from the unanimous vote against Libya in February, arguing that it may mark a milestone in the nine-year-old outfit's struggle for worldwide acceptance.

America's change of heart has helped. Once a fierce critic of the court, it has, in the words of an American official, "reset its default...from hostility to positive engagement" under Barack Obama. But future backing for ICC referrals from Russia and China is far less likely. Most of the Arab world refuses to accept a court that much of the poor world still sees as a Western-dominated tribunal, intent on holding the have-nots to account while giving impunity to the rich and powerful. Jordan is the ICC's only Arab member.

These days the ICC's biggest opponents are in Africa, which provides the court with its biggest group of members (31 out of 114) and is the scene of all the cases currently being investigated or prosecuted: in the CAR, Congo, Cote d'Ivoire, Kenya, Libya, Sudan and Uganda. Accusing the court of unfairly targeting African countries, the 53-member African Union (AU) is again calling for "African solutions to African problems". It particularly dislikes the court's increasing willingness to go after sitting presidents. At its summit next month it plans to extend the authority of its African Court of

Justice and Human Rights to cover criminal as well as civil cases. International lawyers such as Richard Dicker of Human Rights Watch, a New York-based lobby, see this as an attempt to circumvent the ICC.

It may not work. The reason so many African cases are before the court is not because of bias; all the ICC's cases have been referred to it either by the UN Security Council or by the countries themselves. It is because the standards of justice in Africa are often poor. Courts in many parts of the continent are packed with pliant judges keen to do their masters' bidding. Moreover, attempts to create a regional system of African justice have so far failed. The African Court, under the AU's aegis, has never issued a ruling of note. The AU's pledge to ensure that Hissene Habre, held responsible for thousands of deaths as Chad's president in the 1980s, is brought to justice has not been fulfilled. The Southern African Development Community's tribunal, set up in 2005, has been virtually suspended since Zimbabwe refused to accept its ban on the expropriation of white farms and the 15-country regional club proved reluctant to enforce its rulings.

The ICC was set up as a court of last resort. It may not take on cases if the country concerned has a competent, independent justice system ready to prosecute alleged perpetrators and give them a fair trial. Its statutes say nothing about having to defer to regional courts. Many autocratic African leaders appear ready to protect their erring colleagues from the law in case they may one day need the favour returned. The AU has been trying for three years to get the Security Council to suspend the ICC's proceedings against Mr Bashir. Kenya, which as an ICC signatory is obliged to help arrest all court indictees, welcomed Sudan's leader to Nairobi, its capital, last year. Mr Bashir merrily visited Djibouti, an ICC member, earlier this month.

The ICC's big weakness, apart from its astronomical cost and drawn-out procedures, is its dependence on others to help arrest suspects. But even this may be changing. South Africa and Botswana have said Mr Bashir is not welcome. Congo has handed over three of its suspects to the court and France a fourth, while Belgium has handed over Jean-Pierre Bemba, a former Congolese vice-president, for alleged atrocities in the CAR. America is actively supporting the hunt for four rebel leaders of Uganda's Lord's Resistance Army, which continues to wreak havoc in the region. Some suspects, including three Darfuri rebel leaders and six Kenyans, have appeared voluntarily before the court. Five others are in custody, including four on trial. So the court, though still widely regarded in Africa with suspicion and sometimes even derision, may yet prove to have teeth.

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Africa's growing middle class

Pleased to be bourgeois

A third of Africans now live on at least $2 per day

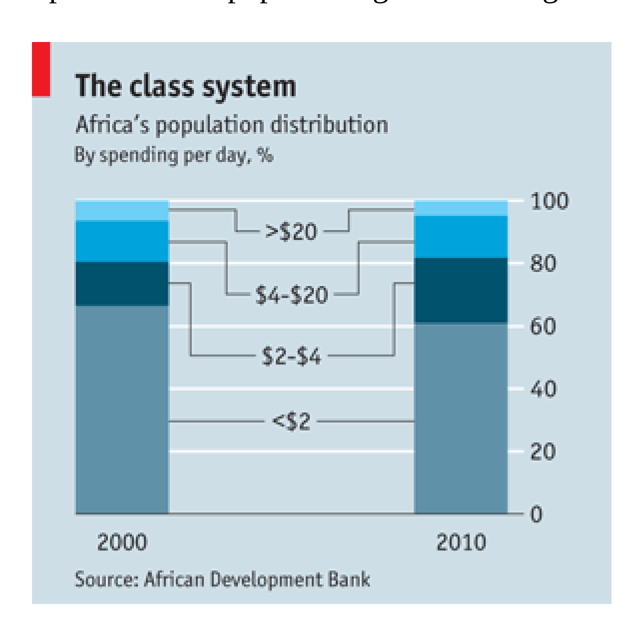


Moving upwards?

IT IS to the middle class we must look for the prosperity of Africa, to paraphrase William Thackeray. Many countries are making a mint from commodities such as oil, copper and gold thanks to sky-high prices. But that is not enough to give Africa a permanent boost. Commodity markets are notoriously fickle and revenues can quickly be squandered.

The true test of progress is whether new riches trickle down from the elite to create a group of consumers large enough to sustain broad economic spurts in the service and manufacturing sectors. If so, a virtuous circle of yet more jobs, new government revenues and better public services beckons, eventually benefiting the poor.

This is indeed happening, according to a report by the African Development Bank. It says a third of Africans are now "middle-class", defined as having between $2 and $20 to spend a day. A decade ago that was true of only a quarter of Africans. This change has occurred in a period of fast population growth among low-income families.



But before Western consumer-goods companies rush to open stores in Ouagadougou or Bujumbura they should look at the report's small print. Two-thirds of that supposed new middle class have just $2 to $4 per day. They may be able to buy a telephone or washing-machine or television, but not often and probably not all three.

Middle-class may, in any case, be a misnomer for such people. In education, aspirations and social status many of them are closer to the European working class of a century ago: no longer starving, but still short of many things the Western middle class of today takes for granted. Their children probably lack a good education. Holiday travel is largely out of reach. Good health care is a luxury. Many start out as subsistence farmers and are among the first in their families to earn a regular wage. They certainly do not carry credit cards or count as part of a global consumer society.

Sharp geographical variations persist. North Africans top the ranking. In sub-Saharan Africa the better the governance, the bigger a country's middle-income bulge. In Botswana, Namibia, Ghana, Kenya and South Africa almost half the population earn more than $2 per day, whereas in the worst-governed countries less than a fifth have managed to cross that barrier.

In any event, improvements in governance, better access to technology, the rapid spread of mobile telephones and the better use of natural resources have begun to raise millions out of dire poverty. The class of Africans with $4 to $20 a day has been stuck at about 14% for three decades. A decade ago, two-thirds of Africans had less than $2 a day. Today that figure is around 60%. And most of those above the barrier are still far from comfortable.

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The crisis in Syria

More stick than carrot

The killing goes on, as presidential emissaries put out feelers for dialogue



In Homs they want to give Assad the hump

PRESIDENT BASHAR ASSAD is using the twin tactics of sending in the tanks and shooting protesters while quietly letting trusted advisers put out feelers to some of Syria's veteran dissidents, in the hope that they may divide and dampen the more youthful opposition-and save his regime.

His priority, however, is still to use force. After nearly two months of protests that have spread to a score of cities, at least 800 people, nearly all of them civilians, have been killed. Parts of several cities remain locked down, including the country's third one, Homs, where there have been unconfirmed reports of mass graves. Banias, a large port, Deraa, the southern border-town where the protests took off, and the small town of Moadimiyeh, on the western fringe of Damascus, the capital, have all been virtually sealed off. The city of Hama, which was almost flattened in 1982 when Mr Assad's father, Hafez, was president, leaving some 20,000 people dead, is also bubbling. Students in Aleppo, Syria's second city, were baton-charged after demonstrating en masse. Across the country, satellite phones have been jammed and the internet often blocked.

The government is in a quandary. The two vice-presidents, Farouk Sharaa and Najah al-Attar, along with a presidential adviser, Bouthaina Shaaban, a seasoned conduit to foreigners, albeit that the international press has been more or less banned from the country, are said to favour dialogue with people in the old opposition. Ms Shaaban has recently met Aref

Dalila, Louay Hussein, Salim Kheirbek and Michel Kilo, among other well-known figures. Others close to the president, such as Manaf Tlass, a son of Hafez Assad's long-serving defence minister, Mustafa Tlass, had previously held talks with the opposition-to no avail. Earlier this year the authorities also had tentative contact with members of the Muslim Brotherhood, whose Syrian leaders are still in exile.

The assorted opposition is unsure how to respond. Some leading lights, believed to include Riad Turk, have argued against meeting Mr Assad's emissaries, presuming that they are bound to be insincere. Indeed, some opposition people who attended earlier meetings, including Fayez Sara, a writer, and Hazem Nahar, a prominent member of the National Democratic Grouping, were later locked up.

The government intermediaries have been loth-and are anyway less able-to make contact with the younger and more radical activists at the heart of the protests. Most of the protesters say they would anyway refuse to talk, arguing that Mr Assad's occasional previous offers of concessions (promises of political reform, salary increases, moves to get rid of emergency laws in form if not in substance, concessions to the Kurdish minority and to conservative Muslims, and so on) have invariably been followed by violent repression. For their part, veteran campaigners, such as Mr Hussein, say they have made it clear they do not represent the protesters nor did they actually engage in negotiation. "We expressed our opinion and tried to suggest a political solution," says Mr Hussein, who, like Mr Assad, hails from the Alawite minority. "We said the government should allow a four-day strike, let people gather, discuss and choose their own leaders in every town and province."

At the meetings that did occur, Mr Assad's officials have sounded nervous. They did not bother to peddle the government's propaganda that the unrest has been stirred up by foreign agents and so forth. Ms Shaaban told the opposition veterans that they should tell the protesters to stop calling for the regime to be toppled. The officials' chief concern has been to prevent the protesters from getting the arms readily available on the black market. The government says that scores of policemen and security forces have been killed in the turmoil; the protesters say such victims were most likely conscripts shot by the more loyal regulars for threatening to defect to the protesters. But some may well have been shot by opponents of the regime, especially in the more tribal areas, where revenge is deemed a matter of honour. Reports, aired by the authorities, that Islamists are becoming embroiled in the protests cannot be substantiated.

In any event, Ms Shaaban declares that the government has the upper hand. Other senior figures in the ruling establishment have been even blunter. Rami Makhlouf, Syria's richest man and a cousin of the president, says the regime will fight to the end, if need be. And as the meetings, purported to seek out dialogue, were proceeding, hundreds more people were being rounded up to join the 7,000-odd who, say human-rights groups, are already behind bars. Football stadiums have been turned into temporary detention facilities.

On May 9th Amnesty International said that more than 350 people had been arrested in Banias alone in a three-day period. Human Rights Watch, a New York-based group, says the prisoners are facing "rampant torture"; many are beaten with cables and whips. Others say they have been blindfolded and made to keep standing for days on end. They are often accused of working for Saad Hariri, Lebanon's former prime minister, once again an arch-enemy of Mr Assad, or for Prince Bandar bin Sultan, a Saudi who heads his country's national security council. Other detainees, after being roughed up, have been let out and told to go and warn others against protesting. The families of some protesters have been rounded up too. In sum, Mr Assad is using the stick a lot more vigorously than the carrot.

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The new Tunisia

Bumpily ahead

Despite recent riots, Tunisians are still on the road to democracy

WHEN they tossed out Zine el-Abidine Ben Ali on January 14th after 23 years of his kleptocratic presidency, Tunisians launched not only their own revolution but a wave of change across the region. Yet four months later there are wobbles in Tunisia itself. Protesters in Tunis have been calling for the fall of the caretaker government, prompting four days of riots

and looting, which were contained once a night-time curfew was reimposed on May 8th. The police have resumed harsh tactics, including the beating of journalists. Rumours are rife of a lingering conspiracy to retain power in the hands of the old elite, despite promises of democracy.

Such evidence of counter-revolutionary regression may be misleading. Though shaky, Tunisia still feels well ahead of its rival in the Arab democratisation league, Egypt. Preparations are under way for a general election, scheduled for July 24th, to choose a 260-person body to draw up a new constitution. After weeks of wrangling, the government has agreed to a proportional party-list voting system in which half the candidates must be women. It has also named a 16-member independent commission to oversee the polls. Some 10,000 senior members of the former ruling party, which dominated Tunisian politics for five decades, have been banned from running for office.

So why the rumpus? Earlier this month, a video clip on Facebook showed Farhat Rajhi, a popular reformist who served briefly as interior minister in the early days of the caretaker government, casting grave doubts on his former colleagues' commitment to democracy. In comments captured by a reporter's hidden camera, he said he was sacked as interior minister because he had objected to the appointment of officials, including provincial governors, tainted by links to the old guard. Most explosively, he suggested that Tunisia's army was prepared to intervene should the election be won by Nahda, an Islamist party that was banned under the former regime but has since bounced strongly back.

Mr Rajhi's musings tallied with widely held suspicions that the caretaker government, headed by the 84-year-old Beji Caid Sebsi, has been dragging its feet over reforms, so prompting the angry protests. Yet Mr Sebsi has categorically dismissed the allegations, and Tunisia's army says it may prosecute Mr Rajhi for defamation.

Public opinion appears divided. Many voices in Tunisia's vibrant blogosphere suggest that the unguarded comments were meant to embarrass the government and perhaps to further Mr Rajhi's own political career. Such views also reflect growing weariness with what has been a long season of protests and strikes. A lot of Tunisians are eager to move on.

Talk of hidden hands manipulating events has long plagued Tunisian politics. What is different now is that such talk is no longer in whispers. With its tourism floundering and problems such as high youth unemployment and poverty festering, Tunisia is in a fragile state. Expectations for change are outpacing the government's capacity to satisfy them. But although the pace of reform may seem ponderous to the impatient young, the country is still heading steadily if bumpily in the right direction-and is on course to emerge as the first solid multiparty Arab democracy.

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Egypt's embattled Copts

Feeling ever more nervous

The country's Christians fear the prospect of sectarian strife



Passions and churches aflame

FREEDOM is not for free, said a sign raised in Cairo's Tahrir Square during the revolution that overthrew Egypt's government. Since then, the price of greater freedom seems to have fallen disproportionately on the large Coptic Christian minority. Sectarian clashes, a dismal feature of Egyptian life for more than a decade, have risen alarmingly.

The latest one, in the Cairo slum of Imbaba on May 7th, left 12 people dead, more than 200 injured and several churches smashed, with one burned to cinders along with Christian-owned shops and homes. The trouble began when a small group of Salafists-Muslims inspired by Saudi-style puritanism, supposedly harking back to the time of the Prophet Muhammad-marched on a church in response to rumours that a female convert to Islam had been kidnapped and was being held there. Local Christians surrounded the building to protect it. With police failing to act and crowds gathering, shots were fired. The melee lasted into the early morning.

For months Salafist preachers had roused passions with similar tales of forced reconversions of women, which the ageing and equally conservative church leadership only feebly denied. The women in most of these cases appear to have resorted to converting to Islam to escape unhappy marriages, since the Coptic church bans divorce. It says they either never converted or sought sanctuary in the church to return to Christianity. The Salafists cite rules of Islam that forbid leaving the faith, and accuse the church of kidnapping and brainwashing their Muslim "sisters".

Such sectarian sniping, inflamed by traditional notions of women as the repository of family honour, has not been the only cause of strife. Other recent cases have seen Muslim mobs attack Christian property following rumours that Christians were hoarding weapons, building churches illegally or engaging in black magic. Egypt's government has paid compensation, offered to rebuild churches, and held public reconciliation meetings between religious leaders. But, wary of riling Muslims, it has seldom brought miscreants to trial.

This time may be different. Mobile-phone cameras captured Salafists inciting violence, as well as gun- and club-wielding men rampaging through a church. Testimony from witnesses suggests that former officers of Egypt's now-disgraced secret police, as well as members of the former ruling party, may also have helped stir trouble. Government officials say they will prosecute offenders to the full extent of the law. Through media commentary and street protests, mainstream Egyptians have voiced outrage and disgust at the strife. Yet Egypt's Christians feel increasingly besieged, fearful that the revolution, which inspired scenes of cross-sectarian harmony, may end up empowering bigots.

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Corrections: Iranian politics and Palestinian reconciliation

In last week's issue in an article on Iranian politics ("Trouble at the top", May 7th, 2011) we miscaptioned a picture, which showed President Mahmoud Ahmadinejad beside a former head of the judiciary, Ayatollah Mahmud Hashemi Shahroudi, not the supreme guide, Ayatollah Ali Khamenei, as wrongly stated. And in our article on Palestinian reconciliation ("It might really happen") in the same issue, we misnamed the chief clerk of the parliament, who is Ibrahim Kharishi, as Hassan Khereishi, who is a deputy speaker. Apologies on both counts.

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German foreign policy

The unadventurous eagle

Europe's biggest economic power seems reluctant to have a foreign policy to match



WHEN Guido Westerwelle, Germany's foreign minister, tires of sneers at home he escapes to the Middle East. In February he celebrated the Arab spring in Cairo's Tahrir Square, drawing rare praise from the German media. In April he was back in the region. These getaways were designed to persuade voters that he is up to the job and the world that Germany is a useful and imaginative member of the western alliance.

Yet both target audiences have doubts. In Germany Mr Westerwelle is the least popular foreign minister on record, partly because he seems more passionate about taxes than foreign affairs. This week he steps down as chairman of his Free Democratic Party (FDP), following its reverses in state elections in March. His position as foreign minister is not yet secure. Meanwhile the global audience is still puzzling over Germany's Libya policy. In March Germany abstained in a UN Security Council vote authorising the use of force to protect Libyans from Muammar Qaddafi's regime. The surprise was not that it balked at sending forces-it is a recent and reluctant participant in such adventures, and even German critics of the abstention think that this intervention is a bad idea. The shock was that, as its closest NATO and European Union allies united to avert a bloodbath on Europe's doorstep, backed by the UN and Libya's Arab neighbours, Germany withheld both legal and moral support.

"Germany has entered a new era of ambivalence and nationalist calculation," wrote Roger Cohen, a *New York Times* columnist. Some French voices echoed many others in demanding that Mr Westerwelle be sacked. German analysts were hardly kinder. The abstention was a "scandalous mistake", thundered Joschka Fischer, a former foreign minister. Mr Westerwelle and Angela Merkel, the chancellor, have called into question "the basic principles of German foreign policy", said *Der Spiegel*, a weekly. Even members of Mrs Merkel's Christian Democratic Union (CDU) found it hard to justify the abstention.

Part of the explanation was surely the state elections that took place days after the UN vote. Mr Westerwelle hoped, mistakenly, that distancing Germany from the bellicosity of France and Britain would help his party. He overruled career diplomats who wanted Germany to vote with its allies. Mr Westerwelle's successful campaign for a temporary seat on the UN Security Council had led Germany's allies to look for more, notes Markus Kaim of the German Institute for International and Security Affairs.

More worrying for Germany's friends is the feeling that the abstention revealed a changed Germany, one of sharp elbows, shallow loyalties and short-sighted reckoning, which will be harder to live with than the more reliable ally of old. The country is pursuing a new "non-aligned foreign policy," claims a recent paper by the European Council on Foreign Relations. Jan Techau, European director of the Carnegie Endowment for International Peace, worries that "this government is creating a huge geopolitical void in the centre of Europe." He adds that the pro-West consensus that has underpinned European peace since the second world war is "slowly dissolving." Some analysts even speak of a *Sonderweg*, a new version of the "special path" for Germany advocated by 19th-century reactionaries.

This new Germany, the argument goes, does what it must to stop Europe's single-currency area from breaking apart but not enough to resolve the crisis (see Charlemagne). It chops military spending with little regard for Europe's (and NATO's) defence needs. Transfixed by the rise of China and other trading partners in the emerging world, it neglects its neighbours. It finds investment in collective endeavours, such as NATO and the EU, altogether too burdensome.

Such anxieties arise because Germany has had more room for manoeuvre since unification in 1990 and yet remains trammelled by old inhibitions. The cold war demanded sacrifices, such as stationing nuclear-tipped Pershing missiles on German soil in 1983. Now Germany is surrounded by friends. The surrender of the D-mark seemed a price worth paying for unification. Now Germany calculates the costs and benefits of saving the euro. Among the constants is Germany's post-war aversion to the use of military force, sharpened by its unpopular deployment in Afghanistan. Unlike in Britain and France (see article), where centralised power and tradition make it easier to take action abroad, in Germany authority is dispersed among various actors and levels of government.

Germany is looking inward partly because its partners are doing so, too. Enthusiasm for European integration has flagged. "You can't be federalist on your own," points out Francois Heisbourg of the International Institute for Strategic Studies in Paris. On the Libya vote, there was no concerted campaign to persuade Germany, he notes. Add to this a chancellor noted more for caution than for vision and a novice atop the foreign ministry eager to score political points, and you have a recipe for disarray.

The problem is not that Germany has made a strategic decision to downgrade its commitment to old alliances, argues Hanns Maull, a political scientist at the University of Trier. It is that Germany has no real "grand strategy". Instead, it reacts to situations as they arise. That need not preclude deft diplomacy. Germany has helped to stabilise the Balkans and is the only non-permanent member of the Security Council working on Iran's nuclear threat. Mrs Merkel and Mr Westerwelle have not allowed ties to Russia to hurt relations with eastern neighbours like Poland. But improvisation can also lead to disasters like the Libya vote. The role of strategy in German foreign policy has been eroding since the 1990s, Mr Maull suggests.

Despite the upheavals of the past two decades, Germany's dilemma has not changed. Even with its waxing economic power, it is too small to wield global influence alone. Yet, within Europe it is too big to act freely without provoking resistance. Germany "needs multilateralism more" than others, says Mr Maull. Few policymakers disagree.

The anchoring of Germany in the West is not in question, says Ruprecht Polenz, the CDU chairman of the Bundestag's foreign-affairs committee. Since the Libya wobble, Germany has scrambled to reassure its allies. Mrs Merkel now proclaims the UN resolution to be "our resolution." Germany has begun participating in AWACS surveillance missions in Afghanistan, freeing up other NATO resources for the Libya operation. Germany may contribute to a UN mission if one is needed for southern Sudan which is seceding in July. (That will coincide with Germany's occupation of the UN Security Council's rotating presidency.)

None of this will be enough. The political and financial costs of sustaining Germany's alliances are rising. Its partners need to know that Germany is prepared to continue paying the price.

French foreign policy

Sarkozy's wars

The voters' backing for foreign military adventures does not help the president



He who attacks may not always win

AS PART of a carefully laid plot to win re-election as president next year, Nicolas Sarkozy wanted to make 2011 the year he turned success abroad into renewed popularity at home. He had in mind the platform of France's presidency of the G8, which has its summit in Deauville later this month, and the G20, which meets in Cannes in early November. Instead, the foreign adventures he has embarked on have been wars, in the name of liberty (Libya) and democracy (Cote d'Ivoire and Afghanistan). Will his new image as war leader win round the voters?

The wars are widely supported. Fully 63% of French voters approve of air strikes on Libya, next to 55% of Americans and just 50% of the British, says an Ipsos poll. There has been cross-party support, even from Mr Sarkozy's detractors. "For sure, I won't vote for Sarkozy," says Bernard-Henri Levy, a left-wing celebrity who helped persuade the president to back the Libyan rebels. "But I'm very grateful for what he did, and very proud of my country."

The wars also mark a turnaround in French diplomacy. After his election in 2007, Mr Sarkozy promised "all those who are persecuted by tyrannies and dictatorships" that "they could count on" France. Yet in a candid interview in *L'Express* magazine, he acknowledged that he just carried on with his predecessors' approach, valuing stability above democracy. Mr Sarkozy let Muammar Qaddafi pitch his tent in a garden next to the Elysee and tried to sell him (and other dodgy leaders) the same Rafale fighters that the French are now using in Libya. Stung by the discrediting of France's diplomacy in Tunisia and Egypt, Mr Sarkozy wanted to make amends. "We are now at a turning-point in French foreign policy," he told *L'Express*. "When people call for their liberty, France will be at their side."

So far, the new line is credible enough. French fighters have carried out a quarter of allied air strikes in Libya, and French officers are helping the rebels on the ground. In Cote d'Ivoire French troops were instrumental in the arrest and ousting of the electorally defeated president, Laurent Gbagbo. Alain Juppe, the newish foreign minister, has restored authority and credibility to French diplomacy. Yet none of this has improved Mr Sarkozy's poll numbers.

Instead, his popularity has sunk to a new low of 20%, according to TNS-Sofres, worse than any predecessor a year ahead of a re-election bid. French voters may approve of Mr Sarkozy's wars, but they still disapprove of his policies at home-and they also doubt his motives. "He was sincere in wanting to stop a massacre in Benghazi," insists Bernard Kouchner, his former foreign minister, who failed to shift French diplomacy and was evicted last year. But he adds that Mr Sarkozy's "foreign-policy line changed because he's a politician, and wants to win the elections."

Moreover, voters are unconvinced that they are any safer as a result. There are fears, fanned by right-wing politicians, about renewed immigration from north Africa. And the French are highly alert to terrorism in the Maghreb, even after Osama bin Laden's death. Four days before his killing, a terrorist attack in the main square in Marrakech, in Morocco, killed 17 people, eight of them French.

Al-Qaeda in the Islamic Maghreb (AQMI), an offshoot of bin Laden's movement, is holding four French hostages in Niger; in a recent video they call on France to withdraw from Afghanistan. Two hostages captured by AQMI in Niger in January were killed in a failed rescue attempt. Only this week French police arrested six men suspected of heading to Pakistan for jihadist training. Bernard Squarcini, head of French intelligence, says France is al-Qaeda's second biggest target after America. And Claude Gueant, the interior minister, said this week that he was worried about a leakage of arms into AQMI-held territory-thanks to the war in Libya.

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Belarus's crackdown

Show trials again

A brutal regime is attacking all its internal opposition

A FEW hours' drive east of the European Union takes you decades back: to political prisoners, a planned economy and black markets. In Minsk, capital of Belarus, the former Soviet republic ruled by Alyaksandr Lukashenka, a Stalinist, show trials are taking place on the EU's doorstep, evoking helpless indignation in the West and silent consent in Russia.

A peaceful protest against a rigged presidential election in December has led to the arrests of most presidential candidates and their backers. Some women were put under house arrest, but most men stayed in jail. A conveyor belt of trials is in motion. Andrei Sannikov, a former diplomat who stood against Mr Lukashenka, faces charges of organising public disorder, which could bring a 15-year sentence. On May 11th his wife, Irina Khalip, a journalist for Russia's *Novaya Gazeta* newspaper, was put on trial, and faces a three-year sentence. International observers, even from Russia and Ukraine, have been kicked out.

The trials have been farcical. On the first day of Mr Sannikov's, many police witnesses failed to turn up, and one claimed a bruise on his backside had briefly put him in hospital. Another supposedly injured party was McDonald's, which lost some business in the disorder. But the sentences are no joke. One of Mr Sannikov's aides, Dmitry Bondarenko, got two years.

The "disorder" actually seems to have been the work of Mr Lukashenka's goons, who staged provocations on election night, smashing windows in a government building and using this as a pretext for arrests. The president has also exploited a bombing on the Minsk subway on April 11th, which killed 14 people, as an excuse to vilify his opponents. "Before the elections we had so much so-called democracy that it has made us nauseated," he said.

Belarus's financial crisis may have more to do with it. Unable to pay for his promises to raise salaries, Mr Lukashenka has devalued the currency. The ruble has fallen by 30%, wiping out people's savings and removing a pillar of Mr Lukashenka's support among older rural folk. Inevitably, Mr Lukashenka blames foreigners. "Today Belarus is being threatened from abroad. A bitter information and political war is being waged against it," he said during a May 9th parade to mark the Soviet defeat of Nazi Germany.

In fact, the EU's response to Mr Lukashenka's crackdown has been feeble. It has reimposed visa bans and targeted the bank accounts of officials but, unlike America, has been slow to impose wider sanctions. At least Mr Lukashenka's tactic of trading political hostages for concessions has got nowhere, as both the EU and America demand an unconditional release of political prisoners. Jose Manuel Barroso, president of the European Commission, refused to be in the same room as Mr Lukashenka during a recent commemoration of Chernobyl. In response Mr Lukashenka resorted to insults. "I don't want to talk about types like Barroso and other morons and arseholes and the like."

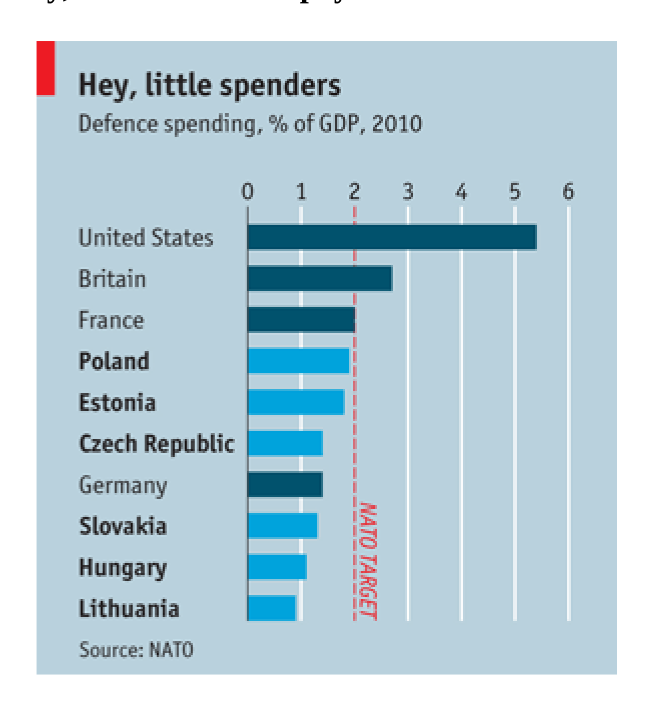
As Fyodor Lukyanov, editor of *Russia in Global Affairs*, a journal, notes, by stepping up repression Mr Lukashenka has destroyed his longstanding game of playing Russia off against the West. His isolation has made him more dependent on Russia, which has been dangling (though not releasing) a large credit line. The Kremlin has seen too many broken promises from Mr Lukashenka to trust him. But it wants to keep Belarus away from the West. Now Moscow can afford to pile on pressure until he cedes control of state firms and subscribes fully to a customs union with Russia and Kazakhstan. Mr Lukashenka may have overplayed his hand. Even as he prosecutes opponents in Minsk, international human-rights lawyers are compiling a case against him, making it unsafe for him to travel anywhere except Moscow and a few other unsavoury capitals.

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Defence spending in eastern Europe

Scars, scares and scarcity

East Europeans whinge about security, but few want to pay for it



ONCE they lobbied hard to join NATO. After Russia's war with Georgia, they begged for coherent plans to defend them. But now the alliance's eastern members are finding it hard to keep defence spending anywhere near 2% of GDP, the official NATO target they agreed to meet. Poland does best: Barack Obama will announce the stationing of a squadron of F-16s there when he visits Warsaw on May 27th. But others are at 1% or even less, or are unrepentantly heading in that direction (see chart).

Iveta Radicova, Slovakia's prime minister, says bluntly that defence is "not a priority". She wants to improve her country's competitiveness and reduce unemployment. Two-thirds of the population, she notes, live on less than euro500 ($720) a month. If defence is cut further, Slovak troops will have to pull out of one of their overseas missions: Afghanistan, Cyprus, Kosovo or Bosnia.

Atlanticist sentiment is ebbing on both sides of the ocean. Once-eager support for American-led wars has faded, shown by the easterners' reluctance to play a role in Libya. Defence spending seems a waste of money on costly foreign-made kit. Many in Washington are cross: their defence planners face hard choices, too. Why spend money protecting ungrateful, stay-at-home skinflints?

Yet the easterners are not only NATO's weakest members, but also its most exposed. It should be in their interest to keep the alliance shipshape. Even scaremongers agree Russia is no immediate threat. Its military reforms are proceeding slowly, at best. Yet its defence spending this year will be around $63 billion, three times as much as that of the new NATO members combined. And even as their spending is falling, Russia's is rising, to 3.2% in 2013.

In exercises in 2009 the Russians practised the invasion and occupation of the Baltic states. That worried military advisers in the Pentagon, who plan big exercises next year in response. Estonia, the smallest of the three, is the only one that comes close to the 2% target: "a model alliance member," comments an American official. The line on low-spending Latvia and Lithuania is icy silence.

The weakest point is air policing. If budgets keep shrinking, few new members will be able to defend their airspace properly (Slovakia will have to junk plans to replace its ageing MiG-29s). The Baltic trio have no warplanes, relying instead on a rota of NATO visitors. That ends in 2014. And why should outsiders bother to protect countries that won't take their own defence seriously?

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Danish politics

To vote, or not to vote?

Danes face a possible early election, with immigration again a big issue

DENMARK'S prime minister, Lars Lokke Rasmussen, tried this week to quell talk of a snap election. "There is much work to be done and it is good that we have several months to do it in," he said. Yet the election buzz continued, with parties dusting down campaign slogans and plans.

The mania has been triggered by tricky negotiations on welfare reform. Denmark's tradition of consensus politics means that long-term reforms in health, defence, welfare and education need cross-party agreement. Such deals, say Danes, ensure continuity when governments change. This time the centre-right government wants to save money by scrapping a pricey early-retirement scheme and raising the pension age. It also wants to cut student grants and cap local-authority spending.

All parties agree that action is needed. With an ageing population and dwindling North Sea oil, Denmark faces a huge deficit by 2020. But the opposition Social Democrats walked out of the negotiations, claiming that the government had broken an agreement on early retirement. "We would prefer to spend our way out of the crisis rather than save our way out," says Helle Thorning-Schmidt, the party leader. Yet she has not offered any alternative, which may help Mr Lokke

Rasmussen. He has long trailed in the polls, but the gap appears to be narrowing, giving his government a fighting chance of re-election.

Whether the prime minister plumps for a snap election in June or waits for the end of his term in November now hinges on the welfare-reform talks. The likeliest outcome is a deal, which would be a coup for Mr Lokke Rasmussen, whose term in office has otherwise been mediocre. Although the Social Democrats have backed off, their small Social Liberal ally still supports the reform. The party's leader, Margrethe Vestager, backs Ms Thorning-Schmidt for prime minister but also wants to dismantle the early-retirement system. If Mr Lokke Rasmussen strikes a deal with her, he may create a damaging split in the opposition.

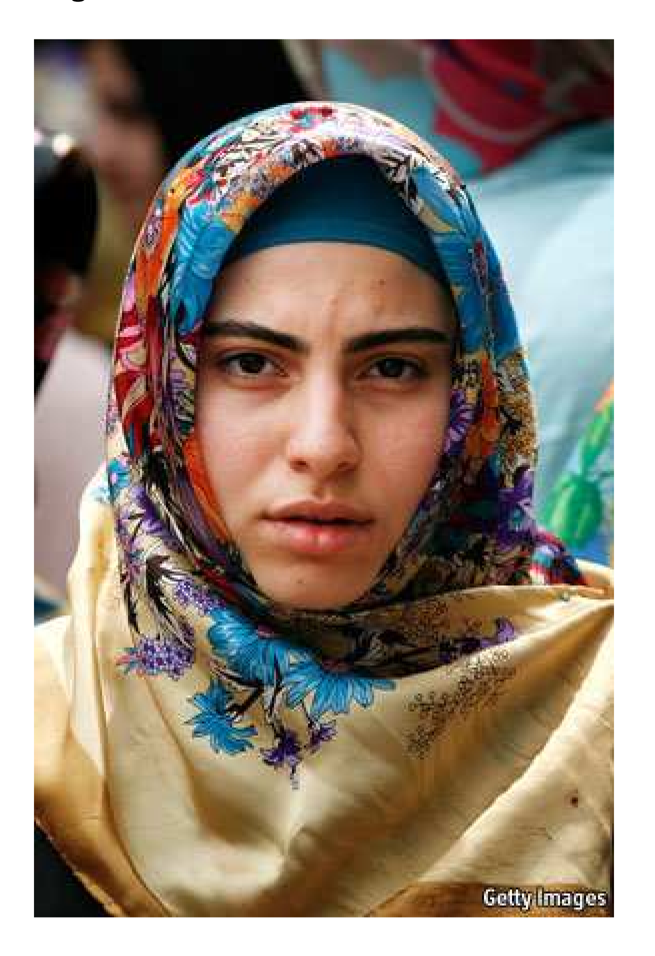
Yet he will still depend on the votes of his longtime far-right ally, Pia Kjaersgaard's Danish People's Party. Ms Kjaersgaard wants to keep early retirement as it is, but she might agree to phasing it out and raising the pension age in exchange for stricter immigration controls and firmer law-and-order policies. She scored a success on May 11th when the government agreed to reintroduce custom checks at Danish borders. Her other demands include more penalties for foreign criminals and a limit on the eligibility of foreigners for welfare and health care.

This is anathema to Ms Vestager, a vocal critic of Denmark's relentless tightening of immigration controls (though a recent official report claimed they had benefited the economy). Just as the pension-reform talks stalled this week, Ms Vestager unleashed a fresh tirade against Ms Kjaersgaard on Facebook. All of which suggests that, whenever the election comes, immigration will once again have a starring role.

Women in Turkey

Behind the veil

Women's influence in politics is growing, but it is still small



THIS week in Istanbul 13 European countries signed a Council of Europe convention on combating violence against women. All 47 members were urged to comply. Turkey pushed hard for the convention, which calls for hotlines, shelters and legal aid for abused women.

So it should. Turkey ranks with Russia as one of the worst countries in Europe for abuse of women. By the government's admission, five women a day were killed by abusers in the first seven months of 2009. A chilling new report from Human Rights Watch, an advocacy group, suggests that the situation is getting worse. It finds that 42% of women over 15 have suffered physical or sexual violence; they are vulnerable even when pregnant. Asli, a 21-year old Kurdish woman, was injected with poison, beaten and raped by her husband and in-laws, and locked in a barn without food or water. She decided to seek help from local prosecutors after her father-in-law burned her arm and declared that "I didn't just get you here for my son, but also for my pleasure." But the prosecutors never contacted her, and she now fears for her life. Asli's story is all too common.

Turkey's mildly Islamist Justice and Development (AK) party is credited with making unprecedented reforms to protect women since it came to power in 2002. The laws are, however, spottily implemented. Single women, divorcees and wives taken in illegal Islamic marriages are not covered. Police often turn away victims on the grounds that "family unity must be preserved." Hulya Gulbahar, a feminist lawyer, says that Turkey's overtly pious prime minister, Recep Tayyip Erdogan, has set the wrong tone. "His diatribes against divorce and calls for women to bear at least three children have made things worse," she claims. Turkey lags in equality, ranking 126 among 134 countries in the 2010 Global Gender Gap Index. Another study finds that women account for four-fifths of Turkey's 5.7m illiterate people.

All this should provide fodder for the opposition in the run-up to a general election on June 12th. In fact, the rare talk of women in the campaign is mostly about footage posted on the internet showing candidates from the Nationalist Action Party (MHP) secretly filmed in compromising situations. The good news is that the number of women elected to the 550-seat parliament is expected to double from the current 50 (9%). But Turkey will still be behind other Muslim countries, such as Afghanistan (28%) and the United Arab Emirates (23%).

The best news is that women are getting organised. Those battling to end restrictions on the headscarf are among the most vocal. Secular women support the campaign to force parties to accept female candidates who cover their heads. "No headscarves, no votes," is their slogan. Although Mr Erdogan and most of his cabinet are married to veiled women, the AK has nominated only one similarly pious woman, for an unwinnable seat. Mr Erdogan's excuse is that his party was nearly banned in 2008 because of its efforts to lift the headscarf ban. A pro-AK newspaper columnist, Ali Bulac, provoked fury when he suggested that veiled women were "spies" acting for secularists or were exploiting their plight to advance their careers. "You would rather have us stay at home and wash your socks," riposted Nihal Bengisu Karaca, a (veiled) columnist at the forefront of the campaign. Will she vote for AK anyway? "Absolutely not," she says.

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Charlemagne

Decision time

Germany continues to dither over how best to rescue the euro



WORKING in the bombastic Nazi-era edifice in Berlin that once housed Hermann Goring's air ministry, then the headquarters of the Red Army and later much of East Germany's communist government, Wolfgang SchÃ¤uble knows more than most how Germany's democratic resurrection and reunification are bound up with European integration. But as the German finance minister wheels himself in to talk to the foreign media (he has been paralysed from the waist down since an assassination attempt in 1990), he cuts a lonely figure. A veteran of German unification, he is the leading pro-European in the cabinet. His instinctive response to the euro-zone crisis is more European integration. Germany is, after all, the euro's principal beneficiary. But his country is ever more sceptical of the European Union and the single currency. German Europhiles feel beleaguered.

Ministers are torn between promises "to do whatever it takes" to defend the euro and the hostility of their voters towards serial bail-outs. The result has been a succession of erratic incremental steps, forced by events and largely driven by tactics. Germany acted to avert the imminent financial collapse of several countries, but often late and never decisively enough to resolve the crisis once and for all. Instead, a year after the rescue of Greece, then of Ireland and now of Portugal, anxiety seems to be growing.

The EU, with power spread across institutions and countries, is ill-designed to act swiftly in a crisis. Germany has to provide leadership, if only because it has the deepest pockets. But it too often seems dysfunctional, partly because of its own decentralised system and partly because being Europe's creditor-in-chief is unpopular. These days Angela Merkel, the chancellor, may be treated in Brussels as an empress, but in Berlin she is just one of many warring nobles.

Take the latest upheaval. Somebody leaked news to *Der Spiegel*, a German news magazine, of a secret meeting of finance ministers in Luxembourg on May 6th to discuss Greece. That was accurate. But the claim that the country was threatening to leave the euro seems to have been wrong, though it caused yet another market convulsion. Jean-Claude Juncker, prime minister of Luxembourg and chair of the euro group of finance ministers, says there was no talk of restructuring Greece's public debt. But who can believe a man whose officials denied that the meeting was taking place, and who has spoken of the need for "secret, dark debates" in economic policy-making? Mr Juncker all but admitted that Greece could not pay its debts, saying it would need "a further adjustment programme". In Berlin this week Mr SchÃ¤uble kept mum about this, to avoid feeding "speculation", though his ministry is now looking at debt restructuring.

In truth it is not speculation but indecision and timidity that are at fault. Germany has made expensive loans to troubled countries, but does not like big fiscal transfers. It said the EU's big bail-out fund would be temporary, but it is being made permanent. Money for rescues is being raised with joint guarantees, yet Germany will not accept common Eurobonds. It has resisted immediately imposing losses on bondholders, yet insists they must share the pain from 2013 and has started to discuss lengthening debt maturities despite fierce resistance from the European Central Bank. It denounces financiers for causing the crisis, but has backed arguments against Ireland burning its bank creditors.

More than once, Mrs Merkel has countermanded Mr SchÃ¤uble. She prevaricated over who should succeed Jean-Claude Trichet as ECB president, finally backing Italy's Mario Draghi long after he had won over other leaders and, indeed, Mr SchÃ¤uble. Even *Bild*, Germany's leading tabloid, elevated Mr Draghi as an honorary German, depicting him with a

Prussian helmet. "What does Germany want?" asks an exasperated Eurocrat in Brussels. Plainly, Germany does not know. To one Berlin economist, "Germany is like an unguided missile over Europe."

Time is not on my side

None of this is to say that Germany is the main cause of the euro's crisis. As much or more blame lies with those that spent irresponsibly, failed to reform in good times and were blind to property bubbles. Yet German hesitation has hindered the search for a solution. Its strategy, in so far as there is one, has followed a twin track. One has been to push others to adopt Germanic rigour through tougher fiscal rules and a "fitness programme" to make economies more competitive. This is meant to prevent a future crisis. As for today's ills, caused by the sins of the past, the answer has often been just to play for time: to try to repair Europe's banks, insist on deficits being trimmed and hope that growth makes the problem more manageable. EU finance ministers want to postpone the reckoning again, perhaps with new loans for Greece, stretching out repayments, reducing the interest rate or even considering a modest voluntary reprofiling of current debt.

But time has a cost. Austerity in troubled countries is deepening recession. Markets doubt that Greece and others can repay their debts even with much more time and fresh loans. And the crisis is tearing at Europe's political fabric. Voters in creditor countries resent endless bail-outs; in debtor countries they resent endless belt-tightening. Even Berlin may be realising that it is time for hard choices. That could mean restructuring debts, imposing losses on creditors and helping banks in danger of collapse. Or it could mean restructuring the euro area through common Eurobonds and fiscal transfers. One option crystallises losses now and raises fears of financial turmoil; the other means an open-ended commitment that risks political rejection. Neither is easy. But prolonged indecision could lead to something even more painful: break-up of the euro, which to pro-European Germans would be a repudiation of post-war history.

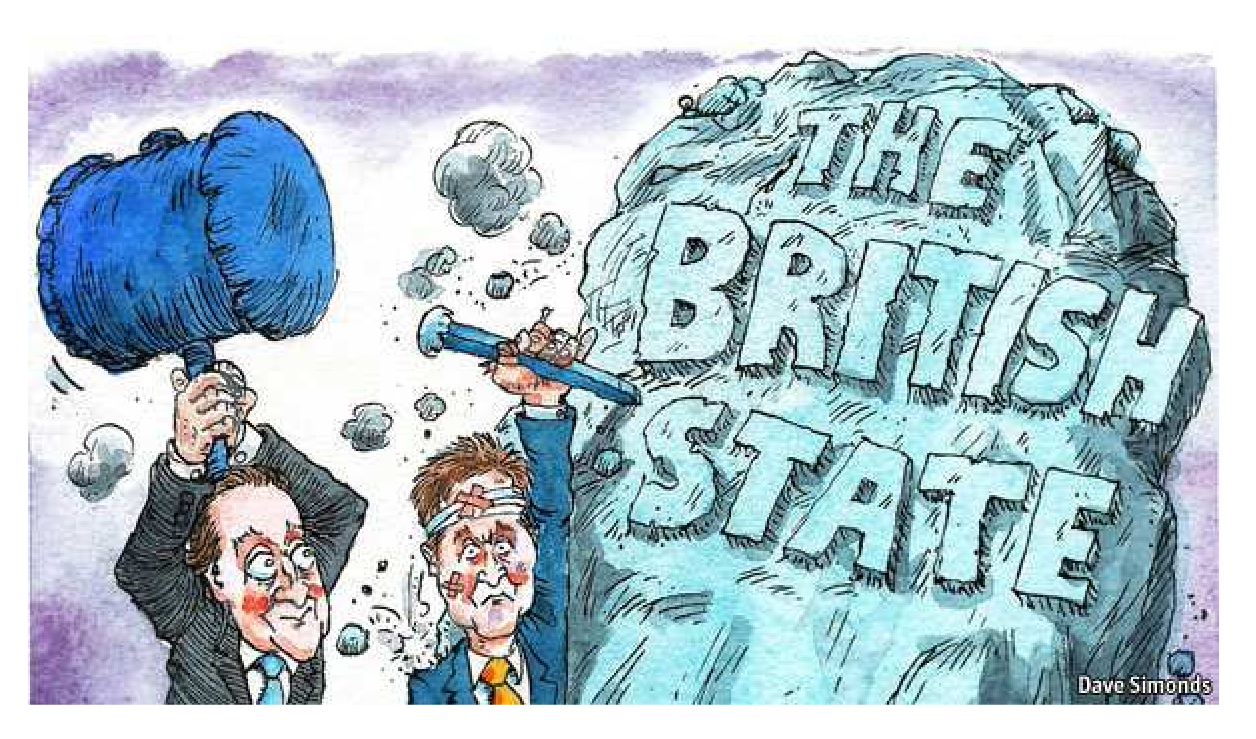
Economist.com/blogs/charlemagne

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The first year of the coalition

The uncivil partnership

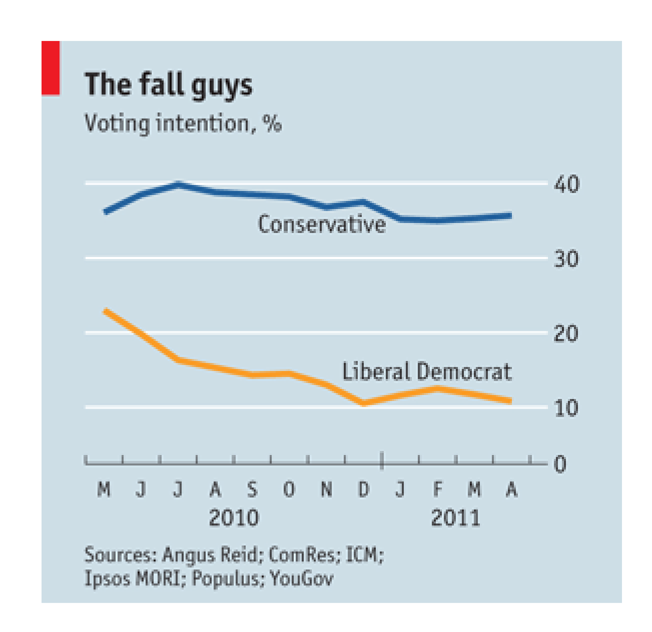
The bonhomie has gone, but the Conservatives and the Liberal Democrats have together begun remaking the state



"THERE'LL be bumps and scrapes along the way." During his beatific, inaugural press conference with David Cameron last May-all jokes and hopes for a "new politics" in the Downing Street garden-Nick Clegg, the Liberal Democrat deputy

to the Conservative prime minister, warned that the sun would not always shine on their new coalition. What he doubtless thought was sober realism now reads like understatement.

The coalition government is suffering both as a coalition and as a government. Tory-Lib Dem relations were poisoned by the campaign for the May 5th referendum on whether Britain should adopt the alternative vote system (AV) for Westminster elections. Mr Cameron's offer of that plebiscite clinched the coalition deal after last year's indecisive general election; but the Lib Dems, who championed the change, say he conspired in the No campaign's gambit of exploiting Mr Clegg's personal unpopularity. Reversals their leader had made for the sake of the coalition, such as supporting a rise in university-tuition fees he once promised to oppose, were used in anti-AV leaflets. Voters rejected the switch by a margin of more than two to one.



The same day's English local elections soured relations further. The Lib Dems were crushed (as they were in Scotland: see article), but the Tories did surprisingly well, picking up 86 extra council seats as their partners lost 748. Opinion polls confirm that the junior partners in the coalition are taking more flak than the senior ones (see chart). Lib Dem ministers rage about the "calculating" and "ruthless" Tories, who in turn resent the sops required to soothe the other side.

Meanwhile there are creeping doubts about the competence and radicalism of the government as a whole. The decision to backtrack on unpopular proposals to sell off forests earlier this year turned out to be practice for a bigger climbdown: plans to remake the National Health Service (NHS) are in danger of crumbling. Broader Tory hopes of opening up public services to new providers may be checked, as Mr Clegg strives to show his party and the electorate that he is taking the edge off Conservative ideology. That Mr Clegg himself is thought privately to support some of these market reforms in the public sector only adds to the sense of chaos.

The bigger picture

Bumps and scrapes, indeed. Anyone judging the government on its recent form might conclude that Britain had been wise to avoid coalitions in the post-war era. Step back from the current turmoil, however, and a more encouraging picture emerges. In its first year, the coalition has actually exceeded many expectations, including those privately held by some of the politicians who founded it.

To begin with, enmity between the two parties has not been growing simplistically and steadily. They generally got on until the AV campaign began in earnest in the spring. Many had expected the relationship to be far worse far earlier. It could yet recover; even if it does not, the coalition is much more likely to become an impersonal, businesslike arrangement than to break up entirely. The Lib Dems have no incentive to provoke a general election while they are languishing in the polls.

More to the point, the coalition was never built on personal relations alone, or even the chilling realisation that a minority Tory government would have looked rocky to bond markets at a time of financial strife in Europe. There was, and is, much ideological overlap between the two parties, or at least their elites. Real power in the cabinet is vested in the "quad" of Mr Cameron, Mr Clegg, George Osborne, the chancellor of the exchequer, and Danny Alexander, the chief secretary to the Treasury. All are market-friendly centrists who think Whitehall is over-mighty.

The same is true of the most influential backroom figures: Downing Street's Steve Hilton and Jeremy Heywood, a special adviser and civil servant respectively. For a coalition, the degree of ideological coherence at the very apex of power is remarkable. Most single-party governments would struggle to match it.

Partly as a result, the coalition has been a qualified success as a reforming government. It has two big missions: to eliminate the structural fiscal deficit by the end of this parliament in 2015, and to redesign Britain's monolithic state by devolving power over public services. It has made progress on both fronts.

The ferocious speed and scale of public-spending cuts were set out in Mr Osborne's budget last June; October's spending review revealed which departments would be cut and by how much: on average, they face 19% reductions in their budgets over this parliament. Britain's lapse into negative growth in the last quarter of 2010 stirred anxiety about the impact of austerity on a weak economy, but, in his second budget in March, Mr Osborne chose not to delay the pending cuts and tax rises. The Lib Dems backed him. Modest growth of 0.5% returned in the last quarter.

Shrinking the state in this way would be a heavy enough burden for any government, but the coalition is also trying to reshape it. Of the four major areas of reform that were outlined last May-education, welfare, policing and health care-only the last has run into serious trouble.

After a slow start, the government's Blairite vision of more choice and competition among state schools is being realised. There are now 629 independent "academies", up from 203 last May, including one in six English secondary schools. The government hopes to make that one in two by the end of the parliament. There has been a slower trickle of "free schools", entirely new state schools with the same operational freedoms as academies. Ministers must eventually grapple with the question of whether to lift the ban on free schools being run for profit. Doing so could attract new providers but rile Lib Dems.

Traditional Tory influence is strongest in welfare policy, the fief of Iain Duncan Smith, a former Conservative leader and now work and pensions secretary. With a bill that is making its way through Parliament, he aims to overhaul a complex benefits system that is riddled with perverse incentives to remain out of work. Some proposals have built on previous Labour policies, such as reassessing claimants of incapacity benefit to see if they can work, and loosening the state's monopoly on helping the unemployed into jobs. Other ideas, such as consolidating various benefits into a single "universal" credit, are new and bold-so much so that Mr Osborne was wary at first of authorising them.

The police, perhaps the most ossified of the public services, are to be exposed to local democracy: next year 41 constabularies are supposed to start answering to commissioners elected by the public. They will be able to set policing priorities and fire chief constables. The idea is to get the police to focus on the crimes that trouble people most, such as the supposedly low-level blight of anti-social behaviour. (The policy was narrowly defeated in the House of Lords on May 11th, but this opposition is expected to be overcome.) The surge of local democracy will not stop there. Pending referendums, 12 big cities outside London could have elected mayors by 2013.

It is only in health that reform is really struggling. The plan was to put family doctors in charge of commissioning secondary services, while subjecting hospitals to more competition. After backing it, the Lib Dems turned against it when unease among voters and clinicians grew earlier this year. Many Tories would also be happy to see a climbdown, which seems likely. One possibility is that primary-care trusts, which currently commission care, survive in some form for longer than planned.

Too often, Mr Cameron's idea of the "Big Society" comes across as a naive faith in voluntarism. But at bottom it is a vision of the state: more locally accountable, more plural in its provision of services and, yes, increasingly giving way to a more active voluntary sector. At least the first two aims are amounting to something. The Lib Dems' attitude to most of these reforms has been acquiescence, or active support. Observers once assumed the two parties were fated to simulate agreement in public while bickering in private. They are beginning to do the opposite-playing up minor differences for political effect.

Before the NHS debacle, in fact, the coalition's foreign policy looked shakier than its domestic reforms. Mr Cameron had planned to be more circumspect abroad than Tony Blair. His foreign secretary, William Hague, wanted to pursue Britain's economic interests rather than change the world. Then, in January, uprisings against authoritarian regimes in the Middle East broke out when Mr Cameron was in the region promoting British business. Suddenly his vision of the world seemed mercenarily narrow. Still, if the capacity to learn from missteps is a measure of leadership, his leading role in the military intervention in Libya, driven by a broader conception of the national interest, has been the high watermark of his premiership.

In terms of governing style, there have already been two phases of that premiership. Mr Cameron began as a chairman. Disdainful of the hyperactive micromanagement associated with Gordon Brown and Mr Blair, he generally left ministers and civil servants alone. His Labour predecessors, smiling wryly, could have foreseen the results: promising reforms stalled while unfinished ideas, such as the NHS plan, were casually signed through by an inattentive Downing Street.

The lesson was learned. Since the turn of the year Mr Cameron has become a hands-on chief executive, working longer hours and recruiting more staff to keep track of policy and its implementation across government. If the NHS fiasco is a delayed consequence of Cameron-as-chairman, there might be fewer unforced errors in future.

His main struggle has been with the civil service. He arrived in office certain that Whitehall was the dutiful Rolls-Royce of legend. Again, Mr Blair could have warned him. Ministers were quickly bogged down in an attritional struggle with a "machine" they saw as hostile to many of their reforms. The prime minister made a coded attack on mandarins as "enemies of enterprise" in March. They bristled, he sought to soothe them, but the tension remains.

Born to rule

Mr Cameron is in his pomp. He has turned out to be a better prime minister than he was a leader of the opposition. Labour MPs admit privately that he is a natural at the job, despite his occasional bouts of complacency. Voters prefer him to Labour's leader, Ed Miliband, by huge margins on questions such as strength, decisiveness and charisma. His role in defeating AV, and campaigning successfully for Tory councillors, has also revived his stock among the Conservative right.

But he will need all the political capital he has mustered. In the next year spending cuts and tax rises will be felt palpably by many more voters, the economy will probably grow slowly and coalition squabbles will continue. A Lib Dem-perhaps Vince Cable, the grouchy business secretary, or Chris Huhne, the ambitious energy secretary-might quit the cabinet. Mr Clegg's initial strategy of "owning" everything the coalition does is giving way to a determination to highlight areas of disagreement.

After a breathless first year, the temptation will therefore be to slow down and split the difference on reforms to keep the coalition together. But such timidity would be uncharacteristic of the prime minister, who has always understood that political capital can be earned by bold moves, and not just spent on them. The prize is a state that, by 2015, could look rather different to the bloated, top-heavy Leviathan bequeathed to the coalition a year ago.

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Elections in Northern Ireland and Wales

The double act continues



In elections for the Northern Ireland Assembly on May 5th, the Democratic Unionist Party and Sinn Fein consolidated their positions as the biggest unionist and nationalist party respectively. The DUP's Peter Robinson (left) and Sinn Fein's Martin McGuinness (right) will continue as first minister and deputy first minister in the devolved executive. Meanwhile, in Wales, Labour performed strongly, narrowly failing to win an overall majority in the devolved Assembly.

Scottish politics

Independence by stealth

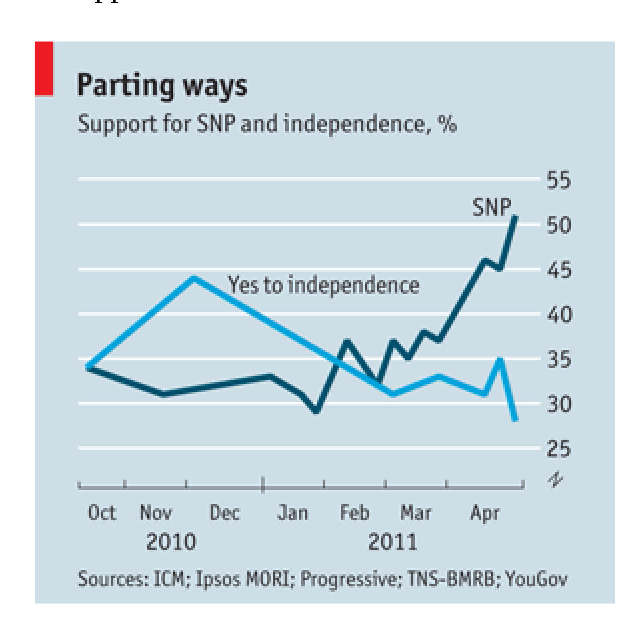
Alex Salmond has defied predictions. Can he do it again?



Salmond's long game

CONFOUNDING all punditry, Alex Salmond, Scotland's first minister, led his Scottish National Party (SNP) to a stunning victory in the devolved Parliament's elections on May 5th. The SNP gained 23 seats to hold 69 out of 129- the first overall majority since the Parliament was created in 1999, and a feat once thought to be impossible under its proportional voting system. Mr Salmond, however, is in no rush to leverage his popularity into a bid to break away from Britain. And the kind of independence he might eventually seek could be much less of a break-up than many now imagine.

The result is certainly catastrophic for his unionist opponents. All three leaders of the other main Scottish parties-the Conservatives' Annabel Goldie, Labour's Iain Gray and the Liberal Democrats' Tavish Scott-swiftly announced that they would quit. The Lib Dems, tainted by their Westminster coalition with the Tories, were reduced from 17 seats to just five. While Labour fared least badly in terms of overall votes, it lost constituencies once considered to be safe and ended up with 37 seats, down from 44. The Tories slipped from 20 to 15.



Was this a vote for leaving the union? Hardly. Neither independence nor the enhancements to devolution proposed in legislation currently wending its way through Westminster featured much in the campaign, which was dominated by public spending and the economy. Opinion surveys consistently suggested that support for independence was much lower than backing for the SNP (see chart).

Mr Salmond duly announced that he might delay the independence referendum his manifesto promised until as late as 2015. His immediate priority, he said, was to win further powers for the devolved institutions, particularly over corporation tax. He put his demands-also including early implementation of mooted borrowing powers, and devolving the collection of income from offshore renewable-energy schemes-to David Cameron. The prime minister is in a tricky position. Refusing the demands risks strengthening Mr Salmond's hand; concessions might suggest to Scottish electors that voting SNP pays dividends.

A devout unionist, Mr Cameron would be well-advised to regard this conundrum as the first skirmish in a long war with Mr Salmond over independence. He should also view current opinion polls as unreliable indicators of how Scots might eventually vote.

That is because the SNP has yet to define what it thinks independence would mean. Some matters, such as control over North Sea oil and gas revenues, are obvious; but other, equally important ones, such as whether an independent Scotland would merely share in the costs and command structures of the British armed forces, or have its own, are not. Mr Salmond is by instinct a gradualist, believing that Scottish sovereignty is most likely to be obtained bit by bit rather than in one go. He would probably prefer to pay for a share of some British functions, for example diplomacy and revenue collection, than instantly to set up separate ones.

James Mitchell of Strathclyde University has just completed a marathon set of interviews with SNP members. He says he was surprised by how relaxed both the leaders and members were about seeking "an ever-looser union" with Britain, rather than an abrupt severance. Mr Salmond's eventual vision of independence might look more like a big but comfortable extension of existing Scottish freedoms than the lonely, impoverished isolation his opponents depict. And as the election showed, he is not to be underestimated.

Misbehaving banks

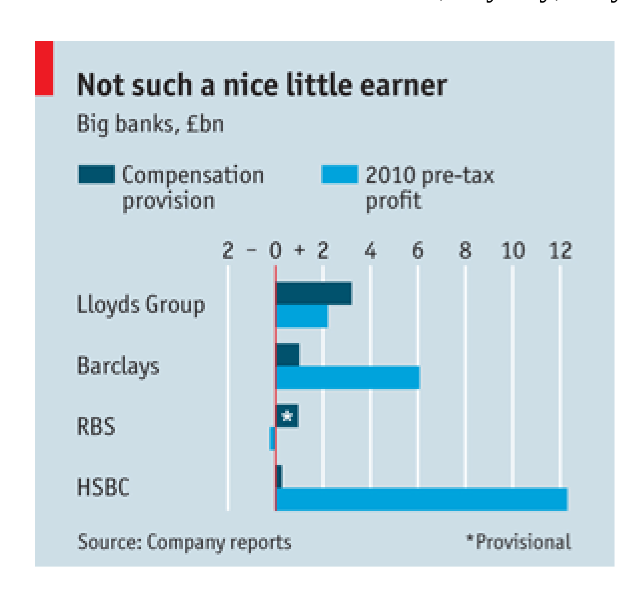
Protection money

A costly debacle has lessons for banks, customers and regulators

EVEN the most hawkish proponents of small government tend to agree that a few sensitive areas of life, such as financial regulation, are best entrusted to bureaucrats. Yet one lesson of a slow-burning case in which Britain's banks have ignominiously agreed to pay billions of pounds in compensation to their customers is that, sometimes at least, amateurs can make the best regulators.

At issue are millions of insurance policies sold since 2005, which promised to make loan repayments if the borrowers lost their jobs (similar but older policies were not covered by the case). Such "payment protection" insurance policies might well be sensible ways for borrowers to manage risk. But millions of them were allegedly sold to people who would never have been able to claim on them because, for instance, they were unemployed when they took out their loans. Others say that they thought the policies were tagged onto the loans, obliging them to take the insurance if they wanted to borrow.

Those complaints are plausible. In the run up to the credit crunch, most British banks were offering personal loans at irrationally low interest rates, instead making their profits from selling concomitant insurance policies. Yet for years the banks countered that instances of bad behaviour were isolated and that, anyway, they were not breaking any laws.



It took a new law that gave new powers to consumer watchdogs to get regulators to pay attention. In 2005 Citizens Advice, a charity, lodged a "super-complaint" that officials were obliged to investigate within 90 days. Their findings started a process that culminated in a High Court ruling in late April-and, this month, announcements by the big banks that they would set aside billions of pounds to cover compensation payments to customers (see chart).

The legal case itself turned on obscure definitions of the regulators' power, but the judgment suggests a clear and ominous lesson for banks: in the era of banker-bashing, simply sticking to the letter of the law is no defence for banks. Regulators and courts seem more willing these days to punish sharp practices, even if it means retrospectively rewriting the rules.

The case also suggests that giving some power to consumer advocates helps keep regulators on their toes. That this sort of behaviour festered for so long points to flaws in the previous government's great regulatory experiment, in which bank supervision and consumer protection were put under the same roof, that of the Financial Services Authority. The FSA's weaknesses in the area of prudential supervision of banks were made clear in 2007 with the collapse of Northern Rock, a mortgage lender. This case shows that the FSA did little better when it came to protecting customers. An imminent regulatory overhaul should help, by giving banking supervision back to the Bank of England, leaving what is left of the FSA to concentrate on consumer issues.

For customers the lesson is a familiar but neglected one: caveat emptor.

The Glencore effect

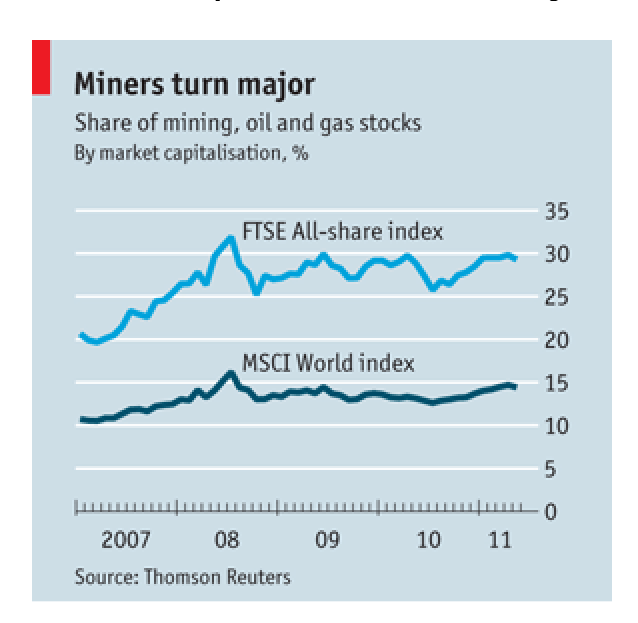
The big dig

The increasing heft of mining firms is a challenge for fund managers

ON MAY 4th Glencore, a Swiss-based commodities trader, published the prospectus for its initial public offering (IPO). The firm, which holds stakes in other mining outfits, hopes to raise $10 billion (pound6.1 billion) by selling a chunk of its equity, making it London's biggest-ever offering.

Nothing lifts the City's spirits quite like a big IPO. The lion's share of the $435m in costs will go to advisers, lawyers, accountants and the 23 banks underwriting and selling the listing. The prospect of Glencore using its new share currency to buy other mining companies makes the dealmakers giddier still. The City's fund managers, however, might have less reason to cheer.

Big mining and oil firms, such as Anglo American, BHP Billiton, BP and Shell have long listed in Britain, which has become the destination of choice for newer firms seeking capital. London's market has a strong brand, its rules are well understood, and there is money sloshing around. The City's big banks live off the fees. But for those whose performance is judged against that of the stockmarket, the commodity fetish is a mixed blessing.



Miners and oil firms already account for some 30% of the FTSE all-share index, twice their weight in the index of global stocks (see chart). Glencore is big enough to qualify for fast-track inclusion in the FTSE index of the 100 largest firms. This hefty weighting makes it tough for fund managers to neglect mining stocks, wary though some of them are of the commodities boom, lest their portfolios trail the overall market. Low-cost funds that mechanically track the FTSE indices have no choice but to buy into a big IPO, whatever its merits.

The upshot is that British-based investors are heavily exposed to a volatile industry. One worry is that the age-old commodity cycle-prices rise; firms invest in costly new capacity; supply increases; profits collapse-is more powerful than the burgeoning demand for raw materials in places such as China. Oil and mining firms carry extra risk for investors because they often operate in politically unstable or inhospitable places. "It is not like investing in Tesco," notes one sceptical fund manager.

The tilt towards miners may work against the interests of other businesses. Technology companies complain that British investors do not value firms with high-growth potential, so wedded are they to more established business models. Tracker

funds have to find money to buy IPOs and so sell other stocks, which might leave the latter open to takeover. A similar gripe is that the FTSE is no longer a bellwether for the British economy, because it is full of firms whose main operations are abroad.

In fact, this is a strength. The stockmarket's international bent means British portfolios are not limited to firms that do most of their business in the slow-growing local economy. And some of the anxiety about mining stocks is merely a pretext to preach the merits of actively managed funds, with higher fees. As for the rest, one solution might be for more managers to agree with investors on a global-equity index as a benchmark. But until such mandates are universal, Britain's savers must hope that the boom in commodity stocks lasts.

Privacy

The right to "no"

Of privacy, the courts and (more importantly) the internet

MAX MOSLEY, who used to run Formula One, has won earlier battles against the media, but this week seemed to lose his war. European judges in Strasbourg rejected his application for a ruling that media outlets must notify the subjects of their stories in advance about any potential breach of privacy. His crusade started in 2008 when the *News of the World* printed a story headlined "F1 boss has sick Nazi orgy with 5 hookers".

Mr Mosley did not deny having sado-masochistic sex with prostitutes. But in 2008 he won pound60,000 in damages and pound420,000 in costs for breach of privacy: the implication that the orgy had Nazi overtones was false, removing the (rather flimsy) public-interest justification, which was based on the fact that his father had been the leader of Britain's fascist party. During that case the paper admitted it had not sought comment from him prior to publication, lest he seek a gagging order.

Mr Mosley argued that this "ambush" breached his right to privacy, under Article 8 of the European Convention on Human Rights. Though the court lambasted the *News of the World* for its use of covert recording and "titillation", it said a broad duty of prenotification would have a chilling effect on free speech (protected by the convention's Article 10). It also noted that no other country has such a tough requirement, and said that such matters were best decided at a national level. A recent British parliamentary inquiry had considered and rejected Mr Mosley's suggestion.

Free-speech campaigners, who think the rich and powerful use privacy to shield wrongdoing, welcomed the decision. Global Witness, an anti-corruption outfit, cites a case brought against it in which the son of the Congolese president used protection-of-privacy arguments after the group published his credit-card bills, which showed his spending on luxury goods. The group won, but took two years to recover the daunting pound50,000 it spent on lawyers. Prenotification would have given the plaintiff a chance to seek a gagging order before the material was published.

Conversely the court's ruling is a setback to those who want tougher protection of private lives from commercial exploitation by the gutter press. But for that cause, technology is now a bigger headache than the tabloids.

A message this week on Twitter, a microblogging service, purported to detail the scandals associated with a number of British celebrities-several of whom are protected by sweeping anonymity orders. These are often issued as interim measures pending a full court hearing, on the grounds that a breach of privacy, if it were permitted, would be irreversible.

If a newspaper breached such an order, it would face heavy fines; its editors could even face jail for contempt of court. Policing the internet is a lot harder. Punishing an anonymous author is tricky. He may have set up an account from any computer (or used software to disguise its address). Tracking him down via a company based (as Twitter is) in San Francisco is tougher still. If he set up the account with no personal details, the hunt may be impossible.

The offending tweet was rebroadcast an estimated 2m times within hours, and also began to appear in pages created in the celebrities' names on Facebook. Some of those mentioned have issued furious denials. Others are keeping shtum. Jeremy Hunt, the Culture Secretary, said it was "crazy" that newspapers were banned from publishing material freely available on the internet. A report on changes to privacy law commissioned by the Master of the Rolls, one of the country's most senior judges, is due out soon. It risks looking out of date before it is even published.

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Miscarriages of justice

Degrees of innocence

The Supreme Court makes it easier for victims of wrongful imprisonment to get compensation



FOR years judges have struggled to define the state's duty to those whom it wrongly imprisons. Under the 1988 Criminal Justice Act, the government must pay up when a person has a criminal conviction overturned, in certain circumstances, or is pardoned because a new or newly discovered fact shows "beyond reasonable doubt that there has been a miscarriage of justice". The idea is to compensate innocent people who do time in error, without rewarding guilty ones whose convictions are quashed on a technicality: the standards for quashing and paying are different. Debate has raged over whether a claimant must actually be proved innocent in order to collect. The government takes that view. Only one of 37 claims made in the year to March 2010 was successful.

On May 11th the Supreme Court came up with a new test for miscarriage of justice, broadening the scope for compensation. A claimant need not prove his innocence, five of nine justices held, but must "show that, on the basis of the facts as they are now known, he should not have been convicted or that conviction could not possibly be based on those facts." They did not go so far as to allow compensation when a new fact only might have prevented conviction.

All three appellants in the joined cases before the court had murder convictions overturned but had been denied compensation. Andrew Adams's conviction was reversed because his lawyers had failed to make use of material that would have undermined the sole prosecution witness. The convictions of Raymond McCartney (now a Sinn Fein politician) and Eamonn MacDermott for killing an RUC policeman were quashed when it became clear the judge had been wrong to dismiss their claims that the police had forced or forged their admissions of guilt. The Supreme Court dismissed Mr Adams's case because the unused material might not have altered the verdict, but granted the others the right to judicial review because, had police brutality been taken more seriously, they would not have been convicted.

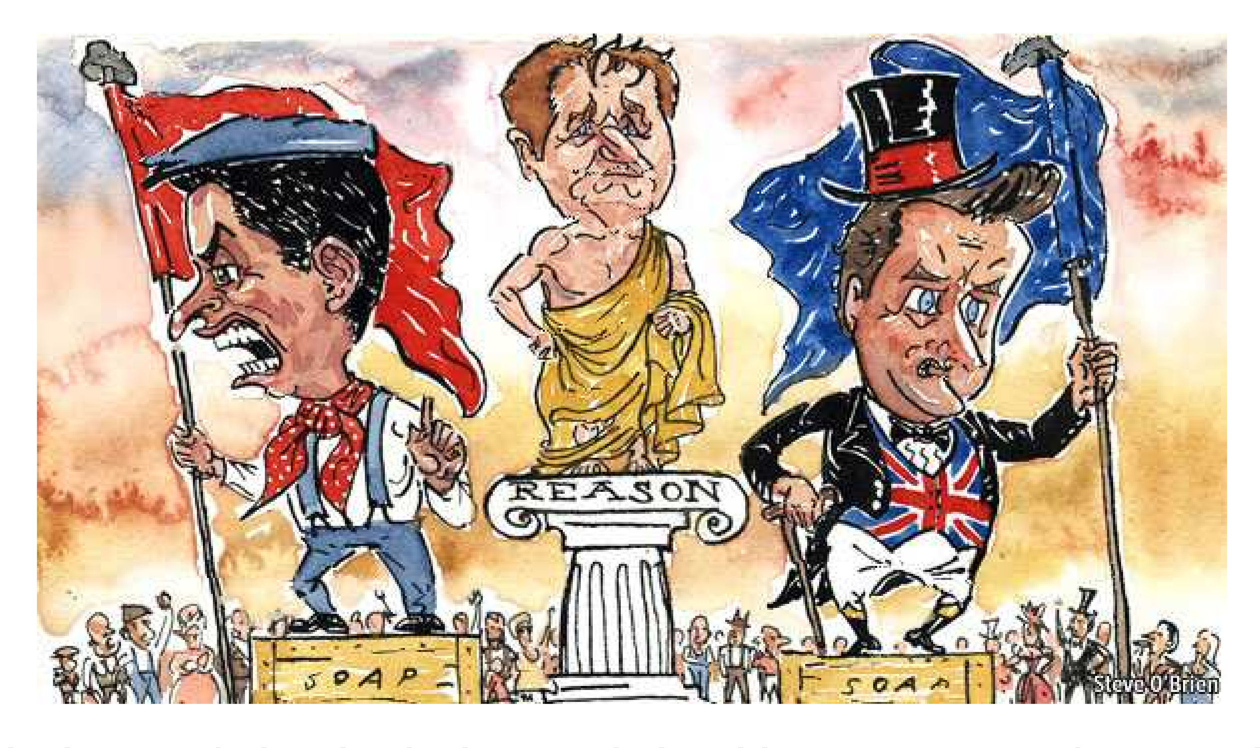
The Supreme Court decision brings clarity to a sensitive aspect of criminal justice. Eric Metcalfe of Justice, a pressure group, calls it "fair, though narrower than we were hoping for". Though relatively few might stand to benefit, they are likely to include such high-profile figures as Barry George-acquitted at a retrial of murdering Jill Dando, a television presenter, but denied compensation for his eight years in prison. He now plans to ask for it again.

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Bagehot

Pride after a fall

Reason will get Nick Clegg and the Liberal Democrats only so far



FOR a British politician, Nick Clegg, the Liberal Democrat leader and deputy prime minister, takes an unusually rational view of how politics should function in his country. This is both a strength and a weakness.

An attachment to reason has its advantages, as Mr Clegg endures an extravagantly awful first anniversary of his decision to join the Conservative-led coalition government. Less Socratic figures might simply have stayed in bed. In local and regional elections on May 5th the Lib Dems suffered their worst council results since the 1980s and a thumping in Scotland, as voters variously punished a one-time party of protest for breaking campaign pledges, joining a Tory-led government or imposing spending cuts (while the Tories, to general astonishment, were rewarded with an increased haul of council seats). Most painfully, a national referendum on changing the voting rules for general elections-a referendum sought by the Lib Dems, who are disadvantaged by the current system-was lost by a margin of more than two to one, after David Cameron threw the Conservative Party's weight (and donors) behind a populist No campaign that singled out Mr Clegg for attack.

The Lib Dem business secretary, Vince Cable (who does not much like Tories), has reacted by calling coalition colleagues "ruthless, calculating and really rather tribal". Flushed with victory, Tory right-wingers (who mostly dislike Lib Dems) are calling for Mr Cameron to get tough with his enfeebled partners, and to stop offering policy concessions to Mr Clegg.

Mr Clegg himself takes a more coolly cerebral line. Addressing party members on May 11th he acknowledged that voters were angry at Lib Dems for breaking promises made before the last general election, notably a pledge to oppose rises in university-tuition fees. But in 2010 both Tory and Labour manifestos had signalled support for higher tuition fees. As Lib Dem leader, he went on, he could not deliver 100% of his manifesto with just 8% of MPs: "You can't be in favour of coalition politics, but against the compromises that coalition necessarily entails." The Conservatives had also ditched or

postponed cherished policies, he noted, on renewing Britain's nuclear deterrent, cutting inheritance tax, picking fights with Europe and building prisons. If Britain kept electing coalitions, Mr Clegg mused, future manifestos might have to signal which pledges are more cherished than others.

In private, Mr Clegg and his inner circle cling to reason as closely as in public. Yes, last week's results were dreadful, they say, but the coalition will not break up: going to the country now would be fatal. Mr Clegg is safe too, they say: no credible challenger would want his job at the moment. The logic is leavened with self-deprecating jokes. If Mr Cameron is Teflon Man, escaping voter wrath over cuts, they jest, Mr Clegg is Velcro Man, to whom all calamities currently stick.

But exasperation also peeps through. Mr Clegg has a habit of deriding opposing arguments as "complete and utter nonsense", and dismissing setbacks as unavoidable. Nobody denies that the Lib Dems did very badly in northern England and Scotland. But, the Clegg camp responds, the Tories were wiped out in the big northern cities years ago, leaving only the Lib Dems for government-haters to kick. Down south, they argue, the Conservatives gained from a splintering of the anti-Tory vote, as some ex-Lib Dems recorded protest votes with Labour or the Greens. Yes, admits a Clegg ally, it now looks disastrous to have sought a referendum on the complicated preferential voting system known as the alternative vote (AV). But AV was all that Labour or the Tories would accept by way of electoral reform and at least offered the promise of extra Lib Dem seats. The advice from European sister parties was that junior partners suffer in coalition: electoral reform looked like vital insurance against such losses.

And yes, says another senior strategist, it now looks a mistake for Mr Clegg to have endorsed Tory policies so warmly in the coalition's first months, and to appear to be Mr Cameron's chum. But with multiparty rule key to Lib Dem ambitions, the Clegg inner circle believed that the British public needed convincing, from the start, that coalition government works.

Never blame the voters

Lots of erstwhile Lib Dem voters are "not very rational", regrets a senior MP. Canvassing before May 5th, he told many that the alternative to a coalition with the Tories would have been a minority Conservative government, possibly followed by a snap election which Mr Cameron would have won outright. Furious ex-Lib Dems said that they would have preferred that outcome.

To be fair, irrationality crosses party lines. Tory right-wingers calling for Mr Cameron to act more like a winner and start squelching the Lib Dems are defying the logic of the 2010 general election. Only together do the Tories and Lib Dems command a parliamentary majority. Until the next election, only the Tories and Lib Dems, between them, have a hope of forming a stable government. Separately, the Tory, Lib Dem and Labour parties are just losers of differing size. From that, everything else flows.

Mr Clegg understands this better than many British politicians, and indeed voters. Just now, his rationality makes him unexpectedly resilient. He believes his party's hopes lie in a full five-year coalition, culminating in an economic recovery for which the Lib Dems will claim a share of the credit. He always knew that 2011 would be a grim year.

But reason gets you only so far, and exasperation with the public is a deadly sin. Voter tribalism and gut instinct dealt the Lib Dems a brutal blow on May 5th. Explaining that result does not change it. To recover, the Lib Dems will need to find new voters. They will not be won by telling the public why it is wrong.

Economist.com/blogs/bagehot

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Correction: Foot-and-mouth disease

Our report on new research into foot-and-mouth disease ("Senseless killing", May 7th) mistakenly said that the Pirbright animal-research laboratory in Surrey was almost certainly the source of the 2001 outbreak. In fact, it was the source of a later, much smaller outbreak in 2007. Apologies.

Group rights v individual rights

Me, myself and them

From indigenous peoples to newly installed migrants, governments face awkward demands for collective exemptions and entitlements



WHEN one category of citizens is singled out for privileged treatment, are the rights of others infringed? Phil Eidsvik, a Canadian salmon-fisher, thinks the answer is yes. He hopes his country's newly re-elected prime minister, Stephen Harper, recalls a pledge he made five years ago: to oppose "racially divided fisheries programmes", in other words, giving special fishing rights to indigenous groups.

But given the storm that Mr Harper's comment provoked-he was accused of stoking white nativism-he is likely to proceed cautiously. And legal moves are now afoot to broaden the rights of indigenous fishermen. At present Canada upholds the rights of aboriginal groups to engage in traditional, subsistence fishing; hence regulators often open a fishery to a particular indigenous group for a limited time before a commercial catch begins.

One tribe, the Lax Kw'alaams, is fighting a legal battle for special rights in the field of commercial fishing, too, challenging the government's contention that commercial harvesting only began with the arrival of whites, and so is not a traditional activity of Canada's first inhabitants. All this horrifies Mr Eidsvik, who argues that the rights of other fishermen (including indigenous ones) are violated when a stretch of water is allocated to a particular tribe. "The individual is completely lost in the conflict over group rights," he says, speaking for the British Columbia Fisheries Survival Coalition, an NGO.

Among the world's liberal democracies, Canada stands out for the entitlements it grants to one group of citizens and for its open acknowledgment that there are hard trade-offs between individual rights and group rights. From South Africa to India, many countries have "affirmative action" policies, with the aim of correcting past wrongs by allocating a disproportionate share of jobs or educational places to groups that apparently need a leg up. But critics of the Canadian system say it goes further; it creates two levels of citizen by excluding indigenous people from conservation rules, and by exempting tribes from the accountability rules that other groups must follow. It is one thing to offer benefits to citizens who are felt to need them, another to water down the principle of equal citizenship.

Canada may be egregious, but, in one form or another, most democracies have to weigh the demands of groups against the rights of individuals-and getting the correct balance has become harder in the age of identity politics, when arguments about culture and even religion have replaced older ones over economics and class. Ostensibly at least, France has remained at the far end of the spectrum from Canada. French officials like to contrast their own policy of equal citizenship with the sloppy *communautarisme*-rights for specific groups-that some countries, including multicultural Britain, tolerate.

Whatever lies behind that French rhetoric, the question of group entitlement has been thrown into sharp relief in all rich democracies by the recent arrival of migrants whose "cultural practices" are at odds with any liberal understanding of rights. Extreme examples include the stigmatising of children accused of witchcraft; the practice of female genital mutilation; domestic violence; and forced marriages with partners in distant lands. Whenever those practices are tolerated, the victims are deprived of basic human rights-and the perpetrators enjoy a peculiar leniency.

As countries wrestle with those problems, realities often differ less than theories do. At least in the recent past, the French authorities turned a blind eye to polygamy among north African migrants. And if there are British inner cities where the Queen's writ (in respect of equality of the sexes, say) hardly runs, something similar applies to the ghettos of Marseilles.

Governments and courts, charged with upholding the ideal of equality before the law, claim to be guided by eternal principles, not fashion-but they are inevitably affected by a climate of opinion created by lobby groups, scholars and international bureaucracies that spend their time debating and defining human rights.

And in that world of wonks and campaigners, there has been more emphasis in recent decades on social and cultural rights-generally demanded by groups-and less on the individual rights which are upheld by classic texts like the American Bill of Rights. For example, the Vienna declaration of 1993, which forms the basis for much for the UN's human-rights activity, incorporates cultural rights as well as a "right to (economic) development".

According to Eva Erman, a professor at Sweden's Uppsala University, "the Vienna text implies there is no tension between individual and group rights, although in practice such a tension often arises." Elsewhere in academia, Will Kymlicka, a Canadian scholar, has argued that individual rights cannot be fully enjoyed without respect for the traditions, languages and religions of groups, because culture gives people "meaningful options". He agrees that culturally defined groups may sometimes oppress their own members, but insists that weak cultures need defending from strong ones. And Amnesty International, the granddaddy of global human-rights groups, broadened its agenda a decade ago to include social, economic and cultural rights as well as freedom from jail and persecution, its first concern.

But as advocates of human rights mull over this year's Arab revolts, there seems to have been a rediscovery of the role of brave individuals who fight old-fashioned oppression in the name of universal rights, not identity politics. In its latest annual report, marking the organisation's 50th anniversary, Amnesty highlights both the role of new technologies in rallying protest, and the price paid by courageous souls who use them. It recalls the death of Khaled Said, an Egyptian who was beaten to death by police while using an internet cafe; and that of Mohamed Bouazizi, a Tunisian whose self-immolation was rapidly relayed round the country through social networks.

Amnesty still thinks rights are interlinked, according to Widney Brown, one of its directors: the cry on the Arab streets is against police repression and torture, but also against economic mismanagement that blights societies. The report rejects a "false dichotomy" between civil and political rights on one hand, and social, economic and cultural ones on the other; but its general tone suggests a renewed emphasis on the ability of individuals to force change in the name of noble ideals.

If the Arab uprisings prevail, will the resulting elected governments impose the will of the majority group-Sunni Muslim in Syria or Tunisia, Shia in Bahrain? Or will they be genuine liberal democracies, with guarantees that members of minorities will be treated no better and no worse than anybody else? That question is impossible to answer in advance, though there are many vulnerable groups, from the Christians of Syria to the Tuareg nomads of the Maghreb, who have reason to fear they might fare worse under free, universal suffrage than they did under secular despots.

Compared with the chaos that could accompany any regime change in the Arab world, decision-makers in stable places like Canada or France have an easy time of it; they are free to experiment and negotiate. And in any lively democracy, groups-defined by language, religion or simply voluntary association around an idea or a pastime-will bargain vigorously over things like language teaching or zoning rights for mosques. But a dangerous line has been crossed, and a bad signal sent to other places, if, in the name of group rights, the principle of equality before the law is openly breached.

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Human-rights abuses

Nothing new under the sun

Some dictators may have fallen, but human-rights abuses continue



Tunisian plainclothes back in action

THE world really can become a better place-that seemed to be the belief of the protesters who have thronged streets in the Middle East. Sadly, those who spoke this week at the Oslo Freedom Forum, a glittering gathering of veterans of human-rights struggles, instead attested to the wisdom of Ecclesiastes: "The thing that hath been, it is that which shall be; and that which is done is that which shall be done."

Take the impact of technology. Facebook and other social media services have created opportunities for dissidents and revolutionaries to organise and voice their opposition. But those in power have discovered that they, too, can use the internet, in their case to stifle freedom of speech. The dream of all dictators is to know as much about you as Google does, says Jacob Mchangama, a Danish human-rights lawyer.

Authoritarian states have also learned how to use the language of human rights to legitimise their oppressive tactics, for instance by claiming to defend religious groups. But their tools of abuse-violence, torture and censorship-remain depressingly familiar. The grand tradition of making opponents "disappear," perfected by the military dictatorship in Argentina in the 1970s, is still flourishing today. In Bahrain doctors and nurses who treated protesters injured by security forces have vanished. Also in Bahrain, Abdulhadi al-Khawaja, the former head of the Centre for Human Rights and a fierce critic of the regime, was seized by armed men in the middle of the night. A month later he reappeared, tortured and is now facing trial.

Post-revolutionary leaders can find it all too easy to slip into the abusive habits of their predecessors. In Oslo Lina Ben Mhenni, a Tunisian blogger, talked of her fear that the transitional government will use the methods of the ousted regime of Zine el-Abidine Ben Ali. When fresh demonstrations broke out in Tunisia in early May, police used tear gas and live ammunition. Journalists were beaten and had their equipment seized.

Nor do governments have a monopoly on violence. From Jamaica to South Africa, gays and lesbians continue to be the victims of vicious intolerance. Lesbians are raped in an effort to "correct" their sexuality. At the Oslo conference the

Jamaica Forum for Lesbians, All-Sexuals and Gays, the first group of its kind on the Caribbean island, said it was remarkable that only one of its founders had been murdered in the past decade, such is the violence typically directed at its people.

Yet there was also brighter news in Oslo. As those in power become more inventive in their clampdowns, so do their opponents. Some have started to help victims make their experiences public. In Malawi children who have been raped or forced into marriage are encouraged to write letters to Radio Timweni, a national news programme, which then interviews them. In the age of Facebook and Google, the truth remains the most powerful weapon of all.

Global road safety

Fighting road kill

The WHO has a plan to make the world's roads less lethal



Just taking the fast lane

SOME mortal threats grab all the attention. Malnutrition, HIV/AIDS and cancer win over rock stars to the cause and provoke grown-ups to wear plastic bracelets. At the other end of the spectrum, past meningitis and diarrheal disease, lies road safety-which has been largely neglected on the global stage. But not for a lack of urgency. Globally, road accidents were the ninth leading cause of death in 2004. By 2030 they could be the fifth, above HIV/AIDS and lung cancer.

The World Health Organisation (WHO) is now trying to make roads less deadly. On May 11th it launched a "decade of road safety", with a plan to save 5m lives and prevent 50m serious injuries by 2020. Officials from Vietnam to Mexico declared themselves determined to prevent traffic deaths. A new road-safety "tag" even graced landmarks in New York, London and Rio de Janeiro.

Yet changing habits on the road will not be easy. Many Europeans like driving fast. In India lanes exist in theory only; motorists make suicidal attempts to overtake and appear to believe their horns confer protection. A survey of 178 countries by the WHO, published in 2009, provides a glimpse of the problem-particularly in the developing world. Poor and middle-income countries account for more than 90% of road deaths, but just 48% of the world's registered vehicles. As economies have surged, so has car use. Road rules and other safety measures have yet to catch up.

Many countries lack basic safety rules that could, the WHO argues, reduce the number of accidents. Easy steps, such as requiring the use of seat belts and setting sensible speed limits, can dramatically reduce the risk of traffic-death. Yet only 38% of poor countries ask both front- and back-seat passengers to wear seat belts. Less than one-third of countries meet simple criteria for reducing speed on city roads.

Even when rules do exist, they are seldom enforced. A country may ban drink-driving, for example, but have no breathalysers. Safety features common in the rich world, such as car seats for infants, are rarities elsewhere. And roads in poor countries are often a danger to pedestrians and cyclists: they account for fewer than 25% of road-deaths in America, but the figure in Thailand is over 80%.

The WHO's plan includes guidelines for improving emergency services, designing roads and enforcing safety rules. These changes could cost $200m each year for the next decade. A $125m gift in 2009 from Michael Bloomberg, New York's billionaire mayor, will help. But more is needed. The WHO thinks road crashes cost most countries between 1% and 3% of GNP. Traffic safety might not be the most thrilling investment. But it is a sound one.

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Demography

...isn't destiny, one hopes

Good and bad news from the UN's population projections

IT IS spring and 100 censuses are in bloom. China, India and America all reported their 2010 results recently. Census-takers are in the field in Germany and Britain. These provide snapshots of current populations. Just as useful are demographic forecasts. These, too, have just appeared, from the United Nations' population division. Every two years, it updates its projections. For the first time, it has projected them as far ahead as 2100.

According to the UN, the world's population will surpass 7 billion at the end of October, a few months earlier than had been expected. The global total will continue to rise slowly until 2100, when it will flatten out at 10.1 billion. During the period of fastest growth, in the late 1980s, the world's population was rising by over 88m a year. Now annual growth is down to 75m and by 2050 it will be only 40m.

The engine of demographic change is fertility-the number of children a woman can expect to have, on average, during her lifetime. Fertility rates have been declining everywhere. This is why in previous projections the UN assumed fertility rates in all countries would eventually fall to 1.85. In 2008 it forecast that, by 2050, 111 nations would have rates between 1.85 and 2.1, the so-called "replacement rate" at which the population exactly reproduces itself.

The new projection uses a different method of calculating future rates, which takes better account of local trends. The UN now assumes more countries than before will be stuck either with high or persistently low fertility, reflecting, in part, the so-called "pause" in declining fertility taking place in Africa. As a result, the UN now says only 51 countries will have fertility rates between 1.85 and 2.1 by 2050.

Population swap

Most populous countries, m

2010		2100 projection	
China	1,341	India	1,551
India	1,225	China	941
United States	310	Nigeria	730
Indonesia	240	United States	478
Brazil	195	Tanzania	316
Pakistan	174	Pakistan	261
Nigeria	158	Indonesia	254
Bangladesh	149	Congo	212
Russia	143	Philippines	178
Japan	127	Brazil	177

Source: United Nations

This change does not affect global figures but has big implications for national ones. Today Nigeria is the world's seventh most populous country, with 158m people. If its fertility declines by no more than the UN assumes, by 2100 it will be the world's third-largest nation, with 730m people-the current population of Europe (see table). Rwanda's population would rise fourfold, to 42m, giving it a density five times that of Japan. China's population would fall by a staggering 450m from its peak in 2025, to 941m.

Some of these projections are incredible: they are warnings as much as predictions. Still, the general picture is probably right. Sub-Saharan Africa is by far the fastest-growing part of the world. Little larger than Europe or Latin America today, it will be bigger than either by the end of the century, and much more than half the size of Asia (it is now only a fifth). The consequences could be severe. The Sahel would be turned into a desert by the soaring population of west Africa. China's dependency ratio-the number of children and old people as a share of working-age adults-is rising faster than Europe's, which will surely require scrapping the one-child policy. And China and India will be riven by conflict if the sexual discrepancies the UN projects come to pass. In 2025 China will have 96m men in their 20s but only 80m women. India will have 126m men in that age group and just 115m women.

Overall, the world's population is increasingly stable. Below the surface, strains are growing.

Index | A special report on international banking

Chained but untamed

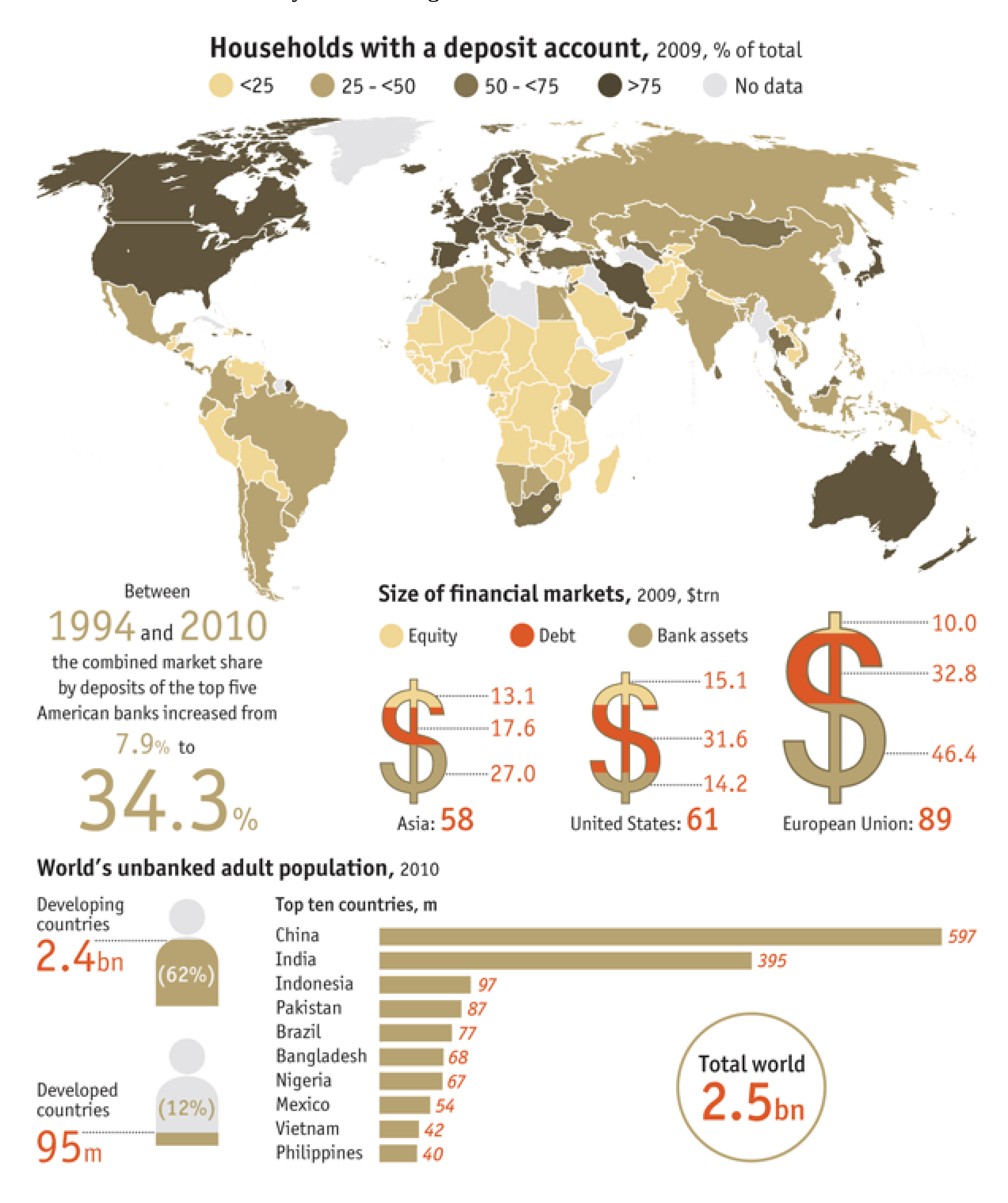
The world's banking industry faces massive upheaval as post-crisis reforms start to bite. They may make it only a little safer but much less profitable, says Jonathan Rosenthal

Key terms:

- **Basel 1-3**
  A series of international agreements on the minimum amount of capital that banks have to hold as a proportion of the loans they have made.
- **Shadow banking**
  Activities similar to banking, such as taking deposits or making loans, that take place outside the regulated banking system.
- **Resolution regimes**
  Special legal forms of bankruptcy for banks designed to keep essential services going even as the rest of the bank is wound up.
- **Living wills**
  Advance provisions made by banks for how to proceed in the event of failure, to minimise damage to outsiders.

THE NEAR-COLLAPSE of the world's banking system two-and-a-half years ago has prompted a fundamental reassessment of the industry. Perhaps the biggest casualty of the crisis has been the idea that financial markets are inherently self-correcting and best left to their own devices. After decades of deregulation in most rich countries, finance is entering a new age of reregulation. This special report will focus on these regulatory changes, which will be the main determinant of the banks' profitability over the next few years.

Start with the additional capital that banks around the world will have to hold. Bigger capital cushions will make the system somewhat safer, but they may also reduce banks' profitability by as much as a third. In addition, they may push up borrowing costs and slow economic growth. Worse, higher capital requirements for banks may drive risk into the darker corners of financial markets where it may cause even greater harm.



Supervisors and regulators almost everywhere are still trying to find ways to deal with banks that have become too big or too interconnected to be allowed to fail. If anything, the crisis has exacerbated this problem. Some of those banks have become even bigger or more interconnected. And governments made good on the implicit guarantees offered to banks, encouraging them to take even bigger risks.

In America the rules to implement the Dodd-Frank act are beginning to take shape. Passed last year, the law runs to 2,319 pages, but it is little more than a statement of intent. Before it can take effect, 11 different agencies have to write the

detailed regulations. These will redefine much of the industry in America and around the world, reversing decades of deregulation in finance in the world's biggest economy.

One key provision is the separation of investment banking from commercial banking, known as the Volcker rule. It will restore some elements of the Depression-era regulatory regime that was meant to ensure that commercial banks did not "speculate" with protected deposits by forbidding them from trading securities. Other regulations in America will set the fees that some of the world's biggest retail banks can charge when one of their customers swipes a debit card. These make no pretence to making banking safer, but reflect politicians' anger at banks and suspicions of those who run them.

Britain, for long the most enthusiastic champion of financial deregulation, is going further still, pondering whether banks' retail arms should be so tightly regulated that they become little more than public utilities. Mervyn King, the governor of the Bank of England, in a recent speech in New York wondered aloud whether the use of deposits to fund loans should be outlawed. In essence, he was questioning a basic building block of modern banking. In April a government-appointed commission said that Britain's banks should wall off their retail arms so they could be salvaged if the rest of the business were to collapse. It is also trying to devise resolution regimes and living wills to reduce the harm done when banks collapse, and it wants more competition in retail banking.

Britain is not alone in reacting strongly. Switzerland, which grew rich as its buccaneering international banks sailed the tides of capital flowing around the world, is now downsizing its global banking ambitions. It plans to impose such strict capital standards on its biggest banks that their investment-banking arms will be forced to shrink or leave the country.

The wave of new regulation comes as many banks are still struggling to regain their footing after the crisis. Across much of Europe, bad debts held by banks are impairing the balance-sheets of their governments. Ireland and Spain are trying to convince bondholders that they can and will repay their national debts, despite the losses incurred by their bankers. Doubts about those two countries' creditworthiness, as well as that of Greece and Portugal, are spreading across the continent's banks, raising borrowing costs and unsettling markets everywhere.

In America big banks are healthier, having largely rebuilt their balance sheets. Yet not all have recovered. The country's smaller regional and community banks include some 800 troubled institutions at risk of being seized by regulators if their capital ratios fall. In both America and Britain households are deeply indebted. For banks, growth in these markets, as across much of the rest of the rich world, is likely to be slow. In Japan banks are well into their second decade of a slow-motion crisis, while in China officials fret that banks are growing too quickly.

Infographic sources: Consultative Group to Assist the Poor; IMF;Federal Deposit Insurance Corporation; Honohan (2008), UNDP and AllianceBernstein; Morgan Stanley; Hanson, Kashyap and Stein (2011); Berger, Herring and Szegö (1995); D. Sheppard (1971); Bank of England; Bank for International Settlements; Reinhart and Reinhart (2010); comScore; national sources; *The Economist*

There is much that regulators around the world are doing well, yet many of their actions have been piecemeal. As a result, they tend to shuffle risk around from one country to the next instead of reducing it across the global financial system. In some ways they have exacerbated the dangers. Dodd-Frank, in its zeal to prevent any more taxpayer-funded bank bail-outs, has curbed the Federal Reserve's ability to provide cash to banks that are fundamentally sound but suffering a shortage of liquidity. That has made it harder for the central bank to act as a lender of last resort, a principle of central banking established almost 140 years ago by Walter Bagehot, a former editor of this newspaper.

The unwelcome consequences of some of the other new rules now being introduced may be greater yet. For example, the European Commission's decision to regulate bankers' bonuses in a bid to limit risk-taking may have the perverse effect of driving up banks' costs and making their earnings more volatile.

The bright spots

Banks in emerging markets face different and far more exciting challenges. They need to grow quickly enough to keep pace with economies racing ahead at breakneck speed and to reach the legions of potential customers in villages and slums who are hungry for banking. Rapid growth and the spread of computing and communications technologies have turned these markets into huge laboratories of innovation. This special report will argue that banks in countries such as India and Kenya have much to teach those in the rich world. These lessons could come in handy, for the torrent of reregulation in

developed countries will soon be raising banks' costs, trimming their profits and forcing some of their customers to look for cheaper banking services.

Listen to an interview with the author of this special report

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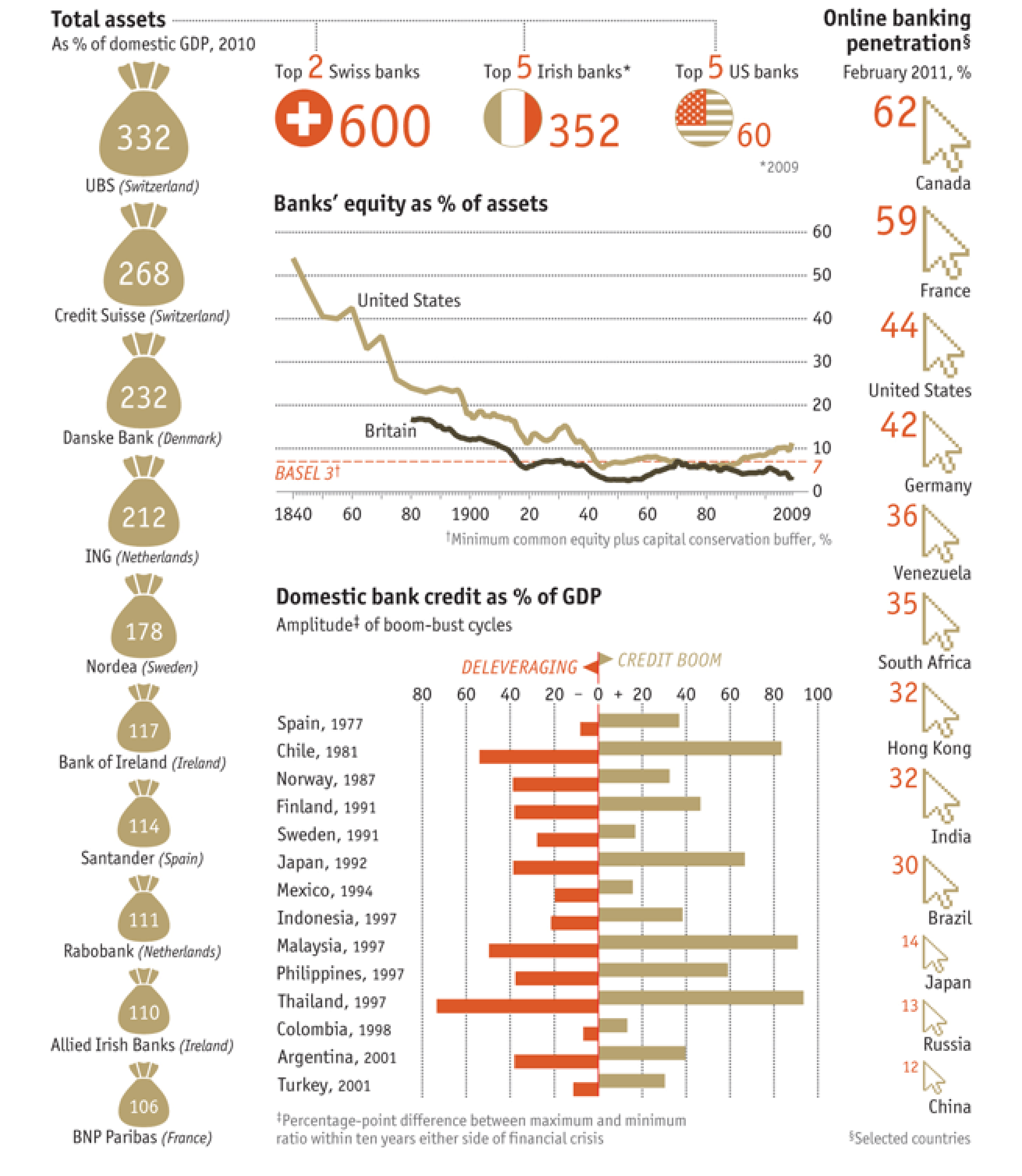
Reregulation

A dangerous embrace

A bank regulator's lot is not a happy one

A SOLDIER HUNCHES over the sights of a heavy machine gun. Its barrel points at the main gate. Out in front, guards briskly move on any cars that loiter. The headquarters of most central banks are described as fortress-like. Few seem quite as impenetrable as that of the Reserve Bank of India.

Its department of banking supervision guards the country's financial system with equal zeal. "Whenever there is a crisis the state will have to intervene," says K.C. Chakrabarty, a deputy governor. "If the state ultimately has to intervene at the very last stage, then why not intervene at the very first stage?"



In India bank supervisors sit on the committees that choose managers of banks owned by the state or get a say on whether the nominated directors of private banks are "fit and proper". They even help to decide how old non-executive directors should be and how much they should be paid.

The central bank also determines what products banks are allowed to sell and has banned all but the simplest of derivatives. It tells banks where they should lend and where they can open branches (which applies to foreign banks as well). "The banking we are protecting in my country is Scottish banking from 150 years ago," says Mr Chakrabarty.

Hands-on regulation of this sort is far more common around the world than the freewheeling variety that banks in the world's financial capitals have got used to. In poorer countries banking is seen as a tool of development wielded through ownership and regulation. In China it is often difficult to tell where the Communist Party ends and the banking system begins. In Russia a state-owned bank, Sberbank, dominates the market. In most of the Gulf region banks count the state among their largest shareholders.

In African and Asian countries that have private as well as state-owned banks, supervisors keep them on a tight leash. "There's a positive attitude towards (banking) regulation in parts of Asia compared with a negative attitude in America," quips Tab Bowers of McKinsey in Tokyo. "In Asia they tell you in a positive sense what you are allowed to do instead of telling you what you can't do."

Before the financial crisis such restrictions were seen as signs of backwardness. In general, banking and capital markets the world over had been steadily liberalising. Limits on foreign ownership of banks and on the kinds of transactions they were able to engage in were being lifted. Rich countries with fairly open markets were deregulating faster than others. In 1999 America repealed the Glass-Steagall act, a Depression-era law separating investment and commercial banking. Across the rest of the rich world banks were given greater leeway on how much capital they should hold and how much risk they could take on. Levels of capital dropped and balance-sheets ballooned.



The crisis put an end to that. Supervisors in many developing countries are now saying that tight regulations saved them from getting into trouble. (Their banks may also have had better things to do with their money than buy worthless claims on American mortgages.) At any rate, regulators now have a good excuse to slow or even reverse the opening of financial markets. In so doing, however, they are also keeping out some rather useful financial innovations that got themselves a bad name. India, for instance, could make good use of securitisation to help it channel the vast sums of money it needs to spend on building ports, roads and railroads. But now regulators are inclined to ban first and ask questions later.

Stop, or I'll regulate

In the old days, in so far as they worried about the risk of banks going bust, regulators usually relied on simple measures of health, concentrating on making sure the right paperwork was in the files, says one senior regulator. "It was a wood-and-trees problem," says another official. "You would go in and come up with a list of 45 things a bank could do better, but you would not be saying: 'What are the five important things that could threaten this bank?'"

In the new world of regulation, supervisors are still doing some of the things they have always done. They are tightening capital standards (see article) and looking far deeper into the inner workings of banks, down to the plumbing that connects them to one another. "Regulators have gone from saying 'tell me all your [payment] systems work' to saying 'show me how they work'," says Simon Bailey, of Logica, a technology firm. "They are shining a pretty bright light on parts of the banking system that are massively complex and, if I'm being polite, slightly dusty."

Far more controversially, though, regulators are now also tentatively stepping over a long-standing divide between enforcing basic rules and playing a part in business decisions. In regulator-speak the difference is between "conduct regulation" and "prudential regulation". Under the old rules supervisors were simply referees trying to ensure that the game was played fairly. The shift is particularly marked in Britain, which once championed "light touch" regulation. Its pre-crisis reticence is now pilloried as a craven surrender to the banks or as a self-serving device for attracting financial activity to Britain. In truth it was neither. The main motivation was the well-intentioned belief that markets are better than governments at allocating resources. In America, too, regulators were reluctant to squash innovation because they thought, in the words of Alan Greenspan, a former governor of the Federal Reserve, that the "self-interest of lending institutions" would be enough to ensure they did not all leap from the same tall building.

In rich countries enthusiasm for new forms of prescriptive supervision seems to be directly proportional to the degree of harm suffered during the banking crisis, or to the threat from failing banks to bring down their governments with them. Britain, which used a larger share of GDP than most other big countries (though far less than Ireland) to prop up its banks, is going further than most to rethink regulation. It has not only reshuffled its entire supervisory apparatus, moving oversight of banks back to the Bank of England; it is also talking about introducing some of the biggest capital buffers in the rich world and telling banks how big they can become.

Switzerland, home to two huge banks, UBS and Credit Suisse, each of which at the time of the crisis had assets at least twice the size of the country's annual GDP, is also proposing unusually strict capital rules and giving regulators a say over its banks' business decisions. America, whose banks suffered huge losses in the crisis without threatening the solvency of the government, is taking a more moderate approach. There, too, however, supervisors are scrutinising business plans and are allowing only selected banks to pay dividends or buy back their shares. Depression-era legislation preventing "speculation" by commercial banks has been dusted off and passed as the "Volcker rule", restricting the ability of banks to trade on their own behalf.

At first glance it seems sensible that regulators should pay attention to banks' health as well as to their conduct. Regulation, after all, is the price that society demands, and banks pay, in return for the implicit promise of a government bail-out if the worst happens. The reason banks are regulated and hairdressers are not is that a badly run barber poses little danger to outsiders. Banks, on the other hand, cause widespread chaos when they collapse. One sick bank going broke can destroy confidence in the entire banking system and start runs that could bring down healthy banks too. Most advanced economies try to prevent that by offering deposit insurance to savers. They also regulate banks to make sure they do not gamble with savers' protected deposits.

But it is not easy to stop banks from making bad decisions. In the past regulators have tended to leave it to the market to judge the health of banks, not least because they themselves did not feel up to it. Legions of clever, well-paid investment analysts and investors failed to see the crisis coming. Those who did are remembered mainly because there were so few of them. Now central bankers and supervisors are expected to make a better job of it, but most would prefer not to get too involved. "We don't want to get into the business of making very close business judgments," says one American official, but "we are making a judgment of our own about whether they have a coherent strategy and coherent risk management."

One problem is that rules and laws are written with the benefit of hindsight. The good ideas that might well have prevented the last crisis, however, can make regulators dangerously overconfident about being able to predict and prevent the next one. Take Royal Bank of Scotland, the bank that in 2008 needed Europe's biggest bail-out. Supervisors on both sides of the Atlantic concluded that the bank's heavy reliance on wholesale markets (very short-term loans from companies and other banks) left it especially vulnerable to running out of money when confidence collapsed. "They should never have been allowed to do that," says one central banker "It's not rocket science."

But at the time it was much less obvious. And a number of other things went wrong with the bank, including its ill-conceived takeover of ABN Amro, the world's largest banking merger at the time, and its expansion into American mortgage markets. Regulators might have prevented the bank from relying so much on wholesale markets, but a disastrous takeover could have wrecked it as well. Bank supervisors can impart only so much common sense to those who think they know best.

Just when you thought it was safe

Besides, the regulators' reluctance to second-guess bank executives was well founded, because it can take them onto dangerous ground. If regulators underwrite certain strategies that seem safe, such as lending to small businesses or helping people buy houses, they may encourage banks to crowd into those lines of business. That can drive down interest rates and lending standards and push up asset prices. If enough banks pile into these markets, downturns in them can affect not just a few banks but the whole system. Paradoxically, the very act of signalling that a market is safe can make it dangerous. It also introduces a form of moral hazard, because banks and their creditors may assume that the government would be duty-bound to bail them out if a closely monitored institution were to fail.

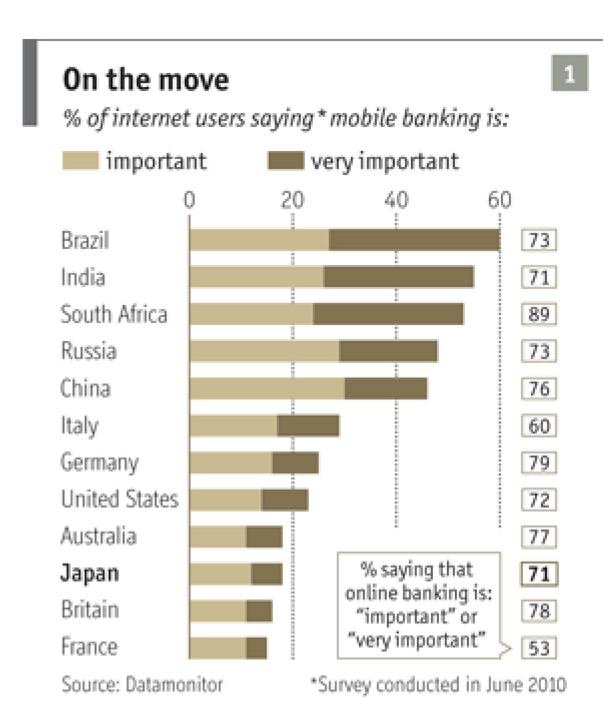
On the other hand over-strict regulation can also be harmful if it stifles financial innovation and squeezes all appetite for risk out of the banking system. In Japan (see box) a banking crisis that started more than two decades ago still lingers on, in part because the country's bankers have become gun-shy and tend to buy government bonds rather than lend money.

And even if supervisors rule wisely, they have to keep it up year in and year out to remain effective. "I worry that supervision is an endless process of having to get better," says a senior regulator in Britain. "You have to keep hiring lots of clever people and you have to avoid atrophy over time."

Most regulators are doing all they can to mitigate these risks. Many are concentrating on changing incentives in the banking system, in the hope that this will change behaviour. Yet they also know that in the new world of intensive regulation the very need for it is an admission of failure-because it implicitly acknowledges that if only banks held more capital, supervisors would not have to work so hard.

Don't sit on your hands

Banking can be too timid as well as too adventurous



BANKING DOESN'T GET much duller than in Japan. The biggest banks there treat the internet as if it had only just been discovered. Their customers are less likely to use mobile or online banking than are their peers in a number of other rich countries (see chart 1). Even its ATMs keep bankers' hours, providing free cash withdrawals during office hours but charging at other times. That is not to say Japanese banking has missed out completely on innovation. The country leads the world in payment cards that can be waved, not swiped. Yet such innovations have generally been introduced by firms other than banks.

On most measures the Japanese banking system looks as if it has slept through the past 20 years. Securitisation never really took off. At its peak, securitised assets stood at less than 2% of the national economy. In contrast, in America in 2007 the value of outstanding securitised mortgages was about a quarter of GDP. Even Japanese bank executives seem cut from an old-fashioned cloth. Most are commercial bankers who have spent their careers working steadily through the branches rather than boarding the express lift from the bond-trading floor straight up to the executive suite. They earn less than their counterparts at big industrial firms. Less than half of the pay of top bank executives is linked to short-term profits or measures such as the performance of the bank's shares, compared with more than 80% of pay in America, according to the OECD. The rigid corporate hierarchies in many banks encourage compliance and consensus rather than bold strategies.

After a financial meltdown it is tempting to find virtue in strongly risk-averse bankers. Japan stood out among rich countries for having been little affected by the crisis. Its banks' write-offs, measured against their total assets, were less than a fifth of those in America and less than half of those in Europe.

Being too cautious, however, can harbour its own dangers. Japan had its banking crisis two decades ago, but it still does not seem to have got over it. Japanese banks posted aggregate losses for ten consecutive years from 1993, and after a brief return to profitability they slumped back into losses in 2008.

To be fair, Japan's banks have had a lot to contend with. Any banking system would be challenged by anaemic growth, grinding deflation and interest rates close to zero. Yet their response has been timid. Opportunities for banks abound across the Pacific rim, yet Japan's bankers have mostly failed to take full advantage of them. In recent years their biggest investments have been in Japanese government bonds rather than loans to customers. The banks now hold 45% of Japanese government debt, almost twice as much as a decade ago.

One reason was that Japan allowed bad debt to fester and encouraged banks to throw good money after bad in keeping zombie companies alive. That doomed the industry for at least a decade. A second is that capital makes a bigger difference than it has generally been given credit for. Japanese banks have had low capital ratios for years. They are buyers of more than half of all debt issued by the Japanese government.

Japan also offers a lesson to supervisors on the dangers of squeezing too hard and stifling innovation and appetite for risk. Banking is an industry that cannot thrive without a touch of animal spirits.

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Capital

How much is enough?

Banks are having to puff up their capital cushions



IMAGINE A DRIVER'S licence that reflected your driving history. The longer you had gone without a crash, the faster you would be allowed to go until your chance of crashing was judged about average, when you would be told to stick to that speed. Or imagine cars with better brakes that could take the place of airbags, or aero-engines whose increased reliability could be offset by less frequent maintenance, leaving airlines about as safe as they were in the 1950s. The main aim of innovation would be not to reduce risk but to make cars or flights cheaper. The idea seems absurd, yet it has underpinned thinking about financial stability for the past three decades-and is proving remarkably persistent.

At the centre of the debate about how safe banks should be is the question of how much capital they should be required to hold. Having too little capital in the system may leave it crisis-prone and in need of regular bail-outs. Too much capital,

on the other hand, could result in huge swathes of the banking business becoming unprofitable. This might result in higher borrowing costs and slower economic growth, though nobody knows for sure. A more pressing danger is that money and risk will flow into more dangerous and unregulated parts of the economy, possibly making the system even less stable.

Capital in a bank does many things. Its first job is to absorb losses, acting as a cushion to protect those who have entrusted the bank with their money from the mistakes of those who own and run it. Its second job is to restrain bankers' instinct for gambling by raising the stakes. It is clear that some banks had too little capital before the crisis. Royal Bank of Scotland, for instance, needed a huge bail-out not because its losses were so large but because it entered the crisis with a dangerously thin capital cushion of only about 3.5%.

This had become possible thanks to two sorts of innovation. The first concerned the rules themselves. Under the original international capital accord struck in Basel in 1988, banks were meant to hold capital worth 8% of their assets. Since some assets are safer than others, and some banks are better at lending safely than others, it seemed sensible to allow banks to calculate how much capital they actually needed, gauged by the probability of their own loans defaulting. Basel 2, a revised set of rules, explicitly permitted this. Banks with the most creditworthy clients could hold the least capital whereas those who pursued riskier business had to hold more. Yet financial models of the riskiness of loans failed badly when put to the test because they were based on data gathered in an unusually benign economic climate.

The second set of innovations concerned capital. In the years running up to the crisis, an army of bankers and lawyers put together new sorts of instruments that were supposed to be as cheap for banks as debt (interest payments in many countries are tax-deductible whereas dividends are not), yet still looked sufficiently equity-like to satisfy regulators. "Every week some banker or lawyer would come in and say they had some new tweak on a capital instrument," says a bank supervisor. "Of course what they were doing was just pushing the boundaries."

The new rules on capital, known as Basel 3, try to deal with both these points by forcing banks to hold a lot more capital and by requiring much of it to be in equity. In essence, they will more than triple the amount of equity that most large banks will have to hold compared with the period before the crisis. Minimum capital is to rise from 8% to 10.5% by 2019, but many banks are getting there early to show they are ready. The increase is much larger than it appears because under the new rules banks must hold at least 7% in equity, the gold standard of capital. These rules have also closed loopholes that allowed banks to hold less capital, for instance by shifting assets off their balance-sheets or classifying them as trading assets.

The massive increase in capital envisaged should show convincingly that the system itself is better buffered against loss. This will involve huge sums of money. Standard & Poor's, a rating agency, looked at 75 of the world's biggest banks and found that between them they will have to raise $763 billion in equity just to meet the new minimum. By McKinsey's reckoning, which includes smaller institutions, European banks will need to come up with euro1.1 trillion in equity by 2019. American banks will have to raise $870 billion.

Many countries are now also considering getting banks to hold an additional cushion of convertible capital and bail-in debt. Convertible capital instruments, usually known as Cocos, are the simpler of the two. These are bonds that turn into equity if the bank's capital ratio falls too low. So far, Swiss regulators have been the most enthusiastic. They have asked their two biggest banks to hold Cocos worth up to 9% of their risk-weighted assets (out of total capital of 19%). As they see it, Cocos are not just a way for the banks to increase their capital reserves on the cheap but may also make them a bit more cautious, knowing that their shareholders will suffer big losses from dilution if the Cocos ever convert. There are still some worries about whether investors will buy the billions of dollars of Cocos that would have to be issued, but they lifted somewhat when Credit Suisse raised $8 billion in February.

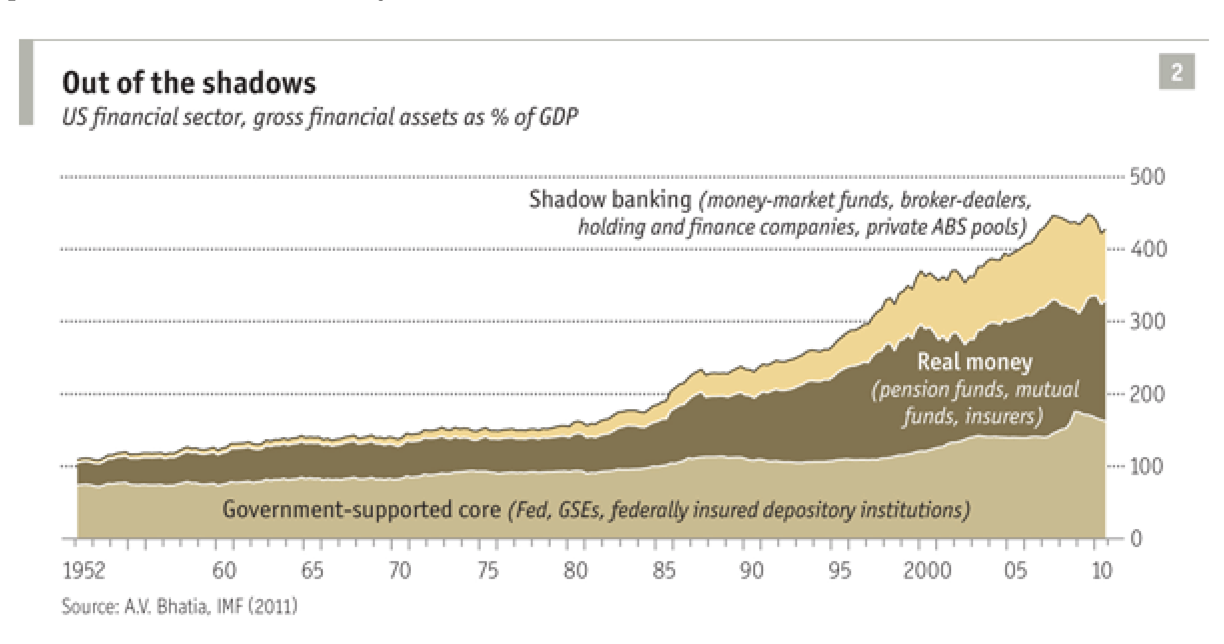
Another potential source of capital for banks would be to convert some of their long-term debt into equity, or bailing the debt in. This would be similar to Cocos, but would ideally apply to all of a bank's long-term debt instead of just a thin sliver of it, so might be expected to be more controversial. Surprisingly, bond investors are generally more comfortable buying bonds that could be bailed in than they would be buying Cocos. The difference, in their eyes, is that the former would convert only when a bank actually went bust, at which point they would be taking losses anyhow, not when the bank was merely ailing. But any transition to these sorts of instruments will take years and they have yet to prove themselves in a crisis.

Two further layers of padding will also be stuffed into capital cushions. The first is a surcharge on very large cross-border banks because of their potential to cause an enormous amount of harm if they fail. The second is a "countercyclical buffer" intended to expand when economies are booming (which should make bubbles slower to inflate) and soften the landing when they crash. It will ensure that banks have surplus capital well above the minimum level to write off bad

debts. This will help not only banks but also the economy as a whole, since the cushion would give banks the required level of capital even as they continue lending.

Countercyclical provisioning has gained much currency since its use by the Bank of Spain in trying to restrain the country's rampant property boom before the crisis. The Spanish experiment did not, in the end, protect the country from a huge property crash and banking crisis, but without it the fall would have been harder still. The idea is sound but difficult to implement, mainly because it requires central bankers or bank supervisors to be brave enough to spoil the party as it gets going.

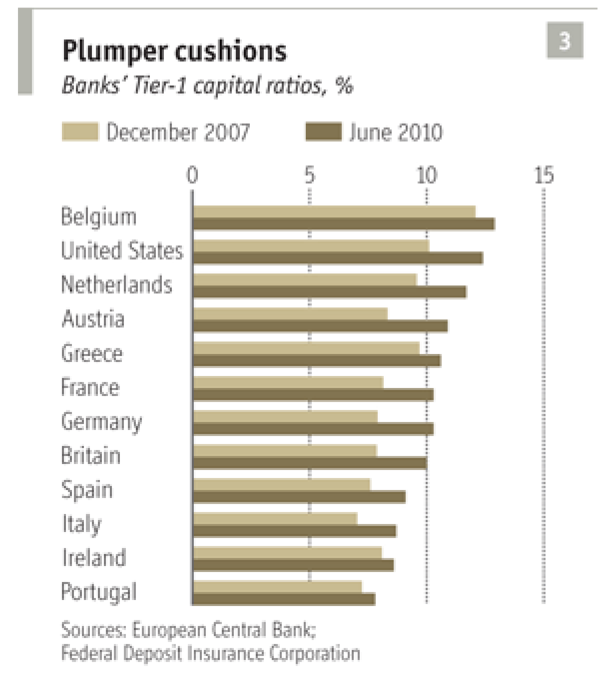
Financial markets are also leaky. Credit can flow across borders and from shadow banks, which complicates the efforts of central bankers who hope to use capital regulation as a way of pricking bubbles, says James Mason of Roubini Global Economics. Japan provides a useful lesson. Two decades ago Japan's finance ministry clamped down on the loans that banks could make against property, hoping to prick the bubble that subsequently burst so catastrophically. Its efforts probably came too late to make much of a difference, but in any case they were thwarted by housing-finance companies able to sidestep the restrictions because they were not banks.



In America and Europe the huge growth of money-market funds and of the shadow banking system in the decades before the crisis largely reflected a shift of risk away from banks to escape regulatory capital charges (see chart 2). This trend was reversed during the crisis but is now resuming, with fixed-income hedge-fund activity and other alternative-asset managers growing much faster than banks.

One solution might be to widen the definition of banks and banking to encompass lending of all kinds. Anil Kashyap of the University of Chicago is among those who reckon that regulators ought to impose capital-like rules on repo markets, a part of the world's financial plumbing that does not usually attract much attention-until it gets blocked.

Deciding how much capital banks need ought to be a fairly simple mathematical process, but there is widespread disagreement even over how much capital banks should have held to have survived the past crisis, never mind the next. The disagreement has intensified in recent months after the publication of two influential papers, one co-authored by David Miles of the Bank of England and the other by a group of economists including Anat Admati and her colleagues at Stanford and Martin Hellwig of the Max Planck Institute in Bonn. They argue that banks should hold two or three times more equity than currently proposed because of the huge costs a collapse imposes on society. Moreover, they think that this should not cost all that much.



Part of the argument is about whether banks should simply have enough capital to survive a crisis without running out of money or whether they should have enough to absorb large losses and still keep lending. If the aim is the former, then the current levels are probably about right. In the recent crisis American banks absorbed losses equivalent to about 7% of assets. Since these took place over time, and some parts of the banks were still generating profits, setting capital levels at about 7% would do. If, however, the aim is to ensure that banks not only survive but are strong enough to keep lending, then capital levels would need to rise to about 15%, according to a paper by Mr Kashyap.

Over the past few decades regulators have tended to err on the side of too little capital. They now recognise their mistake. But most regulators and central bankers, with a few notable exceptions, are still reluctant to ask banks to hold much above 10%. Apart from Switzerland, which is proposing the highest capital standards in the rich world for its own big banks, and Britain, which is pondering a minimum of 10% in equity, it seems unlikely that any other developed countries will demand buffers of 15-20% of banks' assets.

That is because capital is costly. Higher capital standards reduce returns to shareholders and may slow expansion in fast-growing economies such as India or Indonesia, where bank lending is growing by 20-25% a year. Aditya Puri, managing director of HDFC, one of India's fastest-growing private banks, reckons that his bank can fund most of its own growth without having to raise much more capital because it is so profitable. So too can ICICI, India's second-largest bank. Yet the country's largest bank, the government-controlled State Bank of India, may have to ask shareholders for additional capital.

There is little argument that higher capital standards may slow growth, but the scale of the effect is in dispute. The New York Federal Reserve reckons that for each percentage point of extra capital that banks must hold, economic growth slows by about 0.09% a year. The Basel Committee and the Bank for International Settlements reckon the damage is only about a third of that and that it disappears over time. The OECD has come up with a range so wide that it can be reconciled with both. And the Institute of International Finance, a club of banks, reckons the impact could be up to ten times bigger.

Yet it is not clear that this would matter much. The OECD thinks that since the impact on growth will be caused mostly by higher borrowing costs, central banks could offset it with a slightly easier monetary policy. Nor should the costs be seen in isolation. Banks would be buying an insurance policy that might help to avert or mitigate another financial crisis.

It is also useful to think of capital as insurance when looking at the additional capital buffers that large global banks may be required to hold. Under Basel 2 the world's biggest banks were generally allowed to hold less capital than smaller ones because their risks were spread more widely. By and large that turned out to have been sensible. A number of big banks such as HSBC and J.P. Morgan kept credit flowing and assumed risk during the crisis as smaller banks withdrew. Yet the failure of Lehman and the bail-outs of Citigroup and AIG also showed that big and interconnected financial institutions could cause widespread harm if things went badly wrong.

Another lesson of the crisis was that supervisors should look at the health not only of individual banks but of the system as a whole. There is still disagreement about how to measure interconnectedness or think about systemic shocks, yet a

consensus is emerging that banking involves complex networks where risk can arise from the interactions among banks rather than just from individual banks going broke. The implications are enormous because it means that financial systems may crumble even if most banks are fundamentally sound. It also suggests that some healthy banks may have to hold much more capital than they need to stay solvent to help guarantee the smooth functioning of the rest of the network.

Drawing a comparison with biology, Andrew Haldane, an economist, and Robert May, a zoologist, argue in a paper for *Nature* that big financial institutions are "super-spreaders" of financial contagion because they are connected to so many other participants. Just as epidemiologists looking at sexually transmitted diseases such as HIV-AIDS attribute much of its spread to a few very promiscuous people, Haldane and May argue that a few very big universal banks have a disproportionate number of connections to many small ones and thus pose an extraordinary danger. Forcing just a few big banks to adopt safer practices could significantly reduce the amount of risk in the system.

One way of getting them to do this would be to insist that big, systemically important institutions hold an extra layer of capital. There is, however, considerable opposition to a global capital surcharge, not least from the largest and most promiscuous banks. They have the support of regulators in several countries with big banks that largely escaped the crisis, such as France and Japan. These countries argue, with some justification, that size alone is a poor measure of the systemic importance or riskiness of banks. Japan's biggest banks, for instance, are focused on their home market and are funded by deposits in Japan. Were one to fail, it would cause little harm beyond the country's shores, so slapping the same extra charge on all big banks across the globe would not be appropriate.

There is also some doctrinal opposition to having a list of big banks that pose a systemic risk. Any bank on it would be seen as too big to be allowed to fail, deserving a bail-out if necessary. When Elijah Brewer of DePaul University and Julapa Jagtiani of the Philadelphia Federal Reserve looked at bank mergers in America between 1991 and 2004, they found that banks were willing to pay a considerable premium to grow larger than $100 billion in assets, which at the time was seen as the threshold above which banks were considered too big to fail. Another study, by the New York Fed, found that when a list naming 11 American banks that were thought to be too big to fail was released in 1984, their credit ratings jumped and their borrowing costs dropped.

The advantages of a surcharge may, however, outweigh this risk in three respects. The first is that most of the banks concerned are already easily identifiable as systemically important. Naming them would make little difference. Second, a sufficiently large surcharge would reduce the probability of a bail-out by strengthening the banks. Third, if the charge were set high enough to offset the subsidised borrowing costs that come with big banks' implicit state guarantee, it could encourage them to become simpler and smaller.

Much, then, depends on the level at which the surcharge is set. The Basel Committee is likely to release its proposal on how much extra capital big banks should hold in June. The additional amount will probably end up somewhere between 1% and 3% and may consist only of convertible capital instruments, a cheaper and potentially weaker form of capital than equity. If so, the surcharge will be largely symbolic, neither big enough to reduce the risk of systemic failure by much, nor costly enough to encourage big banks to reduce the risk they pose to the system. The onus will then fall on regulators to force banks to cut back on their riskier trading business-and perhaps consider ways of separating their activities to make any failure less damaging.

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Investment banks

Where angels fear to trade

Separating good old-fashioned utility banking from its riskier cousins is not as simple as it seems



CRAPS TABLES AND slot machines mark European banking's glitziest outpost in America. The Cosmopolitan casino, which opened in December in the heart of the Las Vegas strip, is flanked by MGM's City Centre resort and close to a garish Eiffel tower. This is not the casino banking so deplored by regulators and politicians. It is, however, a casino owned by a bank that holds a few unexpected lessons about the relative riskiness of investment banking.

The casino came to be owned by Deutsche Bank not because of any risky bets placed on the floor of the bank's huge dealing rooms, where almost a fifth of the world's foreign exchange changes hands. Nor was it acquired through a trade on the bank's bond-derivatives desk, the world's largest, where clients can swap bets on interest rates.

It was good old-fashioned banking of the sort that regulators hope to encourage that saddled Deutsche Bank and its shareholders with the $4 billion casino. The bank had made a $768m loan to its developers who defaulted in 2008, just as Las Vegas was turning into the black hole of American property values. Faced with getting almost nothing in a fire sale, the bank decided to spend about $3 billion more to finish the project.

Property busts followed by financial crises are almost as old as banking itself. In this crisis, however, losses from residential property were amplified throughout the financial system largely because they had spread from the traditional banking books into the trading books of banks. Even banks that had incurred them were sometimes slow to realise just how much they had lost. If a bank could not be sure of the health of its own balance-sheet, how could it trust those of other banks? Panic spread quickly and interbank lending froze.

One of the main reasons was the assumption of risk by the "prop desks" of big banks, where trades are placed not on behalf of clients but for the banks themselves. If anything about modern banking does indeed have a whiff of the casino about it, it is this. When proprietary trading works well, it can be spectacularly profitable. When things go wrong, however, the results can be devastating. "Dude, you owe us 1.2 billion [dollars]!", said a trader on the phone from Deutsche Bank, giving Morgan Stanley the first clue in 2008 that its star trader had made a colossal error that would ultimately cost the bank some $16 billion, according to "The Big Short", a book on the crisis by Michael Lewis.

To try to limit the damage, regulators in many parts of the world are using a mixture of higher capital ratios (see article), limits on the risks that banks can take and restrictions on the pay and bonuses they offer employees. Of the three, higher capital standards will probably have the greatest impact on investment banking. Their first consequence will be a decline in profitability. HSBC has cut its forecast return on equity to 12-15% and Barclays to about 13%. Credit Suisse and UBS are aiming for at least 15%. Just a few years ago those returns were routinely above 20% and sometimes a lot more.

Falling returns are partly a mathematical phenomenon. If a bank produces the same sort of profits as in the past but has to hold a lot more equity, then its return on equity will be lower. Beyond these sums, however, changing the allocation of capital will produce bigger shifts in the profitability of different businesses as well as in the ways that banks think about

risk. When capital was plentiful, banks could go into businesses that were not particularly profitable but that might earn decent returns if magnified by debt. Now that capital is rationed, banks are spooning it out only to businesses that will make the best use of it.

Most affected are businesses that trade fixed income, currency and commodities (known as FICC). Brad Hintz, an analyst at Bernstein Research in New York, said in a research note that the new capital standards would roughly halve the profitability of sales and trading businesses in American investment banks, which would leave them unable to cover their cost of capital. That is a polite way of saying that their shareholders could do better things with their money. In Europe, investment banks such as Barclays Capital and Deutsche Bank will be stretched to earn enough money from their trading businesses to keep them going in their current form.

In Switzerland's rarefied Alpine atmosphere, capital is scarcer still. The reason is found behind the little boxes with bright red flowers nestling against the windows of the Swiss National Bank in Bern. The central bank is determined to curb the giant Credit Suisse and UBS, which own two of the world's biggest investment banks. For a country of fewer than 8m people, these banks are not just too big to fail: they are too big to save. They have been asked to boost their capital reserves to 19%, about twice the level likely to be imposed on big banks in the world's financial capitals. That may well persuade the Swiss banks to get out of much of their investment-banking business altogether. "It is not necessary for them to be the number one in capital markets," says one Swiss official. "Private banking is a very good business for them."

Switzerland has placed itself at the extreme end of a spectrum of higher capital charges, and is thus likely to see its big banks shrink more than most. But it is just a matter of degree. A scarcity of capital is pushing banks everywhere to concentrate on businesses that use less of it, such as trading foreign exchange, where the banks do not have to assume much risk, says Jason Napier, an analyst at Deutsche Bank. Many banks are also concentrating more on fee-paying activities, such as helping their largest corporate clients sell bonds, advising on takeovers or looking after rich clients' investments. These strategies are not new, but they are being pursued more vigorously than before.

The Volcker pinch

A second regulatory threat to investment-banking profits comes from the limits imposed on proprietary trading in America. The policy, widely known as the "Volcker rule" after the former Federal Reserve president who proposed it, is a half-hearted throwback to Depression-era barriers erected between investment and commercial banking. The full details of the Volcker rule will not be finalised until the second half of 2011, but regulators will probably either ban outright or, more likely, limit in value, transactions where banks are clearly placing a bet rather than facilitating a trade for clients. "We don't want to get into the business of saying 'this trade is OK'," says one official. Drawing the line is not easy. Even the most unadventurous bank will be making trades of its own to hedge against adverse movements on transactions it is executing for clients.

Even so, American banks are already reining back on the risk-taking parts of their business and, like the Swiss, trying to expand in areas that use less capital. That seems to be leading to three unintended consequences. The first is that when investment banks can no longer smooth out their earnings with timely sales of bonds, their profitability will probably become more volatile rather than more stable. That will make their shares riskier in the eyes of investors and may encourage them to take risks in areas not covered by the new rules. Second, the markets most big investment banks are trying to squeeze into are becoming ever more concentrated. The five biggest traders of foreign exchange now account for some 55% of the market, compared with 36% a decade ago. If this continues and spreads to other markets, such as fixed income or commodities, it could perversely increase the total level of risk in global banking by making the entire system more vulnerable to the failure of one big institution.

It is difficult for regulators to lean against this concentration. Economies of scale are elusive in most areas of banking, particularly in retail. In wholesale investment banking, however, size is one of the keys to success, partly because the trading of bonds, currencies and derivatives is moving to electronic platforms which are costly to install and run. Celent, a consulting firm, reckons that banks across the world will spend about $170 billion on computers and technology this year. A bigger share of trades also provides an information advantage as banks get to see what their clients are doing and stay a step ahead. For small banks, the trick is to concentrate on just a few markets where they can play a dominant role.

The overall pot is also shrinking. Analysts at Morgan Stanley reckon that revenues from trading bonds and from fixed income, currencies and commodities will fall by another 3-5% this year after contracting in the second half of 2010. That matters, because this area has been the main source of earnings in investment banking over the past few years.

A third likely consequence of the Volcker rule is that it will push a great deal of risk into places where it might be less easily managed. The rule applies to the global businesses of American banks but only to the American businesses of other banks. That leaves European and Asian investment banks free to shift such businesses elsewhere, but American banks will have no such option. Property prices in expensive parts of London will probably benefit, but it is not clear that the export of risk from America will make the global banking system safer.

Bonus issue

The traffic is not just one way. European banks, for their part, are losing business to American ones because of new regulations at home. The European Commission has drafted strict new rules limiting the size and composition of bankers' bonuses (see article). Under those rules only about 20% of bonus payments will be in cash, with the rest deferred for as long as six years. At Credit Suisse, for instance, most investment bankers will have to wait about four years for their bonuses after a profitable year. And if their divisions subsequently post losses, those payments may be reduced or even cancelled.

There is a certain logic to deferring bankers' pay: the old bonus arrangements may have encouraged them to pursue short-term profits even at the cost of long-term risk. Yet banks still need to secure talented staff, so they are increasing the basic salary they offer. Analysts at J.P. Morgan reckon that the rules will disadvantage European banks in relation to their American rivals, particularly in competitive and fast-growing markets such as Asia. Within Europe mid-sized investment banks may also lose out to much bigger ones that can afford to pay higher basic salaries. Small boutique investment banks and hedge funds, both of which are exempted from the limits on bonuses, will probably gain from reduced competition.

Ironically, the new rules may also make investment banking even riskier for investors. Bonuses typically account for about 60% of the total wage bill at investment banks, which in turn generally consumes about 50% of revenue. With a bigger share of salaries now fixed, earnings at European investment banks will become even choppier. This may prompt some investment-banking businesses to move to America.

Might this herald a general trend for banks to start moving around to escape restrictive rules? There have been mutterings that the two big Swiss banks may try to work out ways of circumventing regulation at home by listing their investment banks abroad. Similar rumblings are heard in London. HSBC conducts a review of its domicile every three years anyway, which would make a move easier. Barclays has said it would consider leaving.

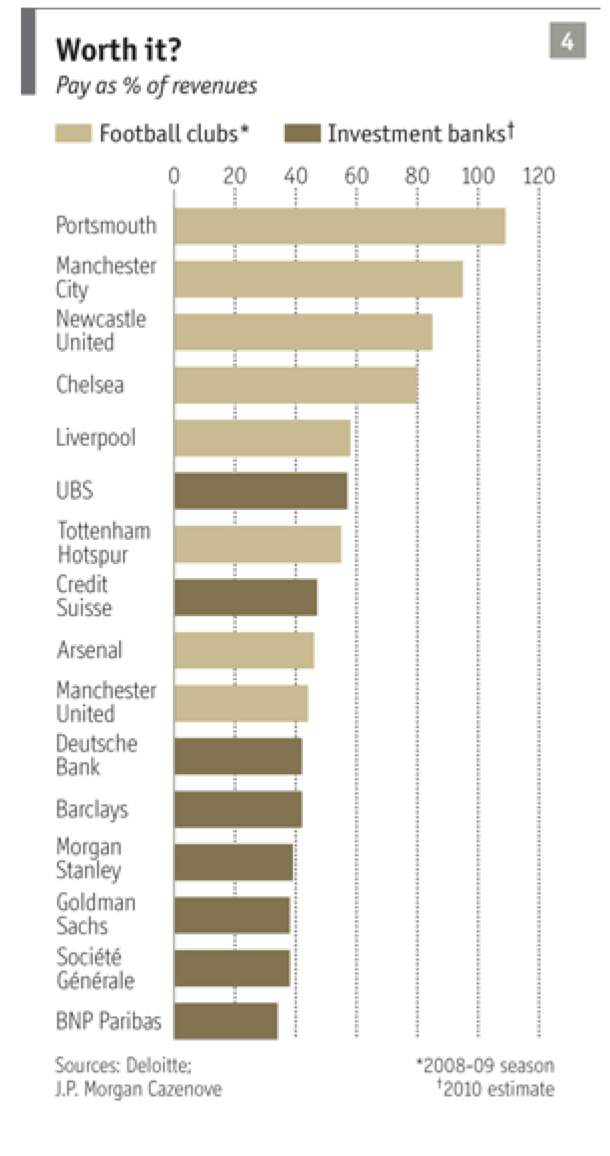
Other European banks may have even more compelling reasons to want to move. Healthy banks in countries with unhealthy finances now pay a significant penalty when raising funds. Spain's Santander and BBVA, for instance, have sounder balance sheets than many rivals abroad yet their borrowing costs are 1-1.5% higher, reflecting doubts about the creditworthiness of their government.

Yet in practice banks rarely up sticks. In the end they and their governments need one another. "We'd be nationalised," exclaims the boss of one largish European bank at the thought of a move, though only after mulling it over for a minute. Besides, banks are not as fleet-footed as they may seem. Investment bankers can fly around the world doing deals. Funds, too, can move from one country to the next. Yet an enduring lesson of the crisis is that wholesale money markets can dry up from one day to the next. In response, banks are now working far harder to gather local deposits wherever they do business. That means they have to attract and keep retail customers whose savings are the new lifeblood of finance.

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Fantasy paypackets

The parallels between footballers' and bankers' rewards



SHERMAN MCCOY, A bond trader imagined by Tom Wolfe in his 1980s novel "The Bonfire of the Vanities", memorably struggled to explain to his daughter how he made his money. His wife explained that Daddy earned a living by collecting tiny crumbs of cake each time a slice of it was passed from one person to another. If anything shows the age of the book, it is this description of banking. Two decades later investment bankers were getting far more than crumbs. Total pay on Wall Street last year was higher than it had been before the crisis (although it was split among more people), according to Bloomberg. In Europe the banking sector's total wage bill jumped by about 8% last year, overtaking the previous record set in 2007. British investment bankers are doing best of all, with pay in some banks increasing by as much as 20%.

Politicians fume that banks are taking public bail-outs with one hand and doling out the cash to their employees with the other. Britain's chancellor of the exchequer, George Osborne, struck a curious deal in February under which banks agreed to pay smaller bonuses, mainly in return for larger basic salaries, but only for a year. In Switzerland and the European Union banks face restrictions on how much of a bonus they can pay in cash straight away.

Restricting bankers' pay may make political sense, but is it good economics? Professional football may offer a lesson. The market for talent in both banking and professional sport is fairly transparent (at least to the participants) and fairly efficient. Both are meritocratic. Teams with better players win more often. Banks with the best traders or dealmakers generally earn more money. If talent and performance are strongly correlated, it seems reasonable that pay should follow.

Investment banks typically set aside about half their net revenues for pay and bonuses. The most successful banks, like the best football clubs, manage to keep a bigger share of revenues, partly because there is so much more of it and partly because they are able to offer prestige as well as money. Weaker banks, and ailing clubs, pay out 80% or more of their revenues in the hope of making their way up the league table. In England, which has the biggest and richest football clubs, revenues have more than tripled since 1997, but pay has increased even faster. In 2008-09 the top English clubs handed over more than two-thirds of their income to their players. Almost three-quarters of them lost money.

But what happens if clubs (or banks) are not able to pay as much as they would like to? America's National Football League provides an interesting example. The NFL is a cartel that imposes hard caps on players' pay. Its rules leave little

room for a market for talent. Footballers who do not like the money can either leave the game or go on strike, as they did in March. As a result, players earn relatively less than their European counterparts (on average about 57% of the clubs' revenues), and clubs or franchises are a lot more profitable.

Caps on bankers' pay, if they could be rigorously enforced, would probably have the effect of redistributing income from banks' employees to their shareholders. That may not be what regulators are hoping to achieve. But in any case it would take a cartel to ensure that bankers are kept in their place. American footballers put up with lowish pay because they lack other options. They probably also love the game. Investment bankers, on the other hand, are free to move-and they are unashamedly in it for the money.

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Retail banks

In vogue

Despite low interest rates and dismal returns, there is hot competition for customer deposits

WITH REGULATORS TURNING off the tap that used to allow investment banks to draw easy profits, the industry is looking to retail banking for new sources of earnings. This is a huge business. In America retail and commercial banking generate revenues of some $750 billion a year, or just over 20% of total global banking revenue, according to Novantas, a consulting firm. And in Europe, where capital markets are still less developed than in America, the fortunes of most big banking groups will depend on how their retail banks are doing over the next few years.

An equally pressing reason for the sudden revival of big banks' interest in the tedious business of taking deposits and processing payments is that they can no longer rely on wholesale money markets for most of their funding because that would leave them vulnerable to sudden freezes. Those that depend on short-term wholesale funding are required to pay higher interest rates, have lower credit ratings and are subject to closer scrutiny from regulators. Basel 3, along with raising the amount of capital that banks have to hold, will also encourage them to get more of their funding from sources that are less fickle than the money markets. Among the best of these are deposits from retail customers. Regulators love these because they are "sticky": ordinary savers tend not to move their funds around. So banks that wish to survive, never mind prosper, will have to compete a lot harder than they used to for the deposits and cheque accounts of millions of retail and small business customers. They would do well to look at emerging markets, which have seen some of the most exciting developments in retail banking in recent years. Banks there are leapfrogging their rich-world rivals in efficiency, technology and innovation.

"This is the branch," says Om Prakash Bhatt, the recently retired chairman of State Bank of India (SBI), pulling his mobile phone out of his pocket. It seems an outlandish thing to say for a man who until April ran a seemingly hidebound state-owned institution so vast that if it were transplanted to America it would account for about one-sixth of all bank branches there. A decade ago SBI might have confirmed many prejudices about big state banks in poor countries. Despite a mission to serve the poor, its clients were mainly urban bureaucrats. At a time when banks elsewhere were installing huge mainframe computers, SBI balanced its books by hand. Customer payments took almost a month to process and were sent on bits of paper, couriered from one branch to another.

Now SBI and some of its emerging-market peers are teaching the world how to use technology to lower the cost of retail banking, using mobile phones, portable ATMs and the internet. "The really outstanding innovation is coming from emerging markets," says Noel Gordon of Accenture, a consulting firm. "They are using the unbanked as a big laboratory to pilot new ways of banking."

Banks in emerging markets have benefited from investing in technology late in the day. Most of them missed out on the mainframe era, which has left many rich-world banks saddled with ageing and inflexible computer systems. Instead they started spending money at a time when computing power was getting cheaper and becoming integrated with communications systems such as the internet and mobile phones. Whatever market you are in, being able to use zippy new computers is "an unbelievable advantage", says Vernon Hill, who founded America's Commerce Bancorp in 1973 and saw

it grow from a single branch to 435 before its sale to Canada's TD Bank in 2008. He recently opened Metro Bank, Britain's newest retail bank.

Innovation in emerging markets was also prompted by the need to supply a huge market that is hungry for banking. In rural India seasonal farm labourers have work for only about five months of the year, so they need some way of saving. In the past they would buy kitchen utensils and keep them unused, then sell them back to the merchant for a 10% discount when they needed money for food, says Janmejaya Sinha of the Boston Consulting Group in Mumbai. Now technology is supplanting kitchen utensils.

To reach remote villages, SBI is appointing agents equipped with mobile phones attached to card readers. Customers swipe their savings card on the phone and hand their deposit to the agent who pockets the money. When they wish to make a withdrawal, he reaches into his pocket for the cash. The phone really is the branch, extraordinary though it may seem, and it is taking SBI into 100,000 villages that have no other banks. ICICI, India's second-biggest bank, has a similar system of reaching out that is changing the economics of banking. "Transaction values and revenues in the Indian context are much lower, maybe one-tenth of Western banks," says Chanda Kochhar, ICICI's chief executive. "So we have no option but to adapt our technology strategy to this."

In Kenya phone companies have surged ahead of the banks. About 60% of adults there use M-PESA, a system that allows them to transfer money from one mobile phone to another. Yet under a quarter of Kenyans have bank accounts.

Developing countries are also thinking about branch-based banking in new ways. One of Malaysia's fastest-growing banks is RHB's Easy, which is open seven days a week and has no forms for customers to fill in. "It is like a McDonald's," says Mr Sinha. "It only has about five things on the menu but then everything happens in less than ten minutes."

This explosion of creativity is producing rich rewards. Banks in many emerging markets are growing at 20-25% a year, sometimes more. Many banks are reporting returns on equity of 20-25%, so they should be able to generate enough capital from their own profits to keep up as Basel 3 raises the bar.

Might these banks try to apply the lessons from their home markets to expand in America or Europe? Not for the moment, mainly because they are running as fast as they can to keep up with growth at home. "Why would I go there when I am growing at 35% a year here?" asks HDFC's Mr Puri.

Even so, the new ways of banking that they have invented are starting to make their way into developed countries. None is more ripe for this change than America, the world's richest banking market. The plethora of new laws and regulations that American politicians and regulators have introduced to make banking safer includes several concerning retail banking that seem designed to do the opposite. Some of the new restrictions may fundamentally change the way in which retail banks do business and their customers use banking services.

The first challenge to American retail banks will come from two pieces of legislation intended to force big banks to cut the fees they can charge for overdrafts and debit-card transactions. Both laws are meant to protect consumers by ending the cross-subsidies used by banks to make cheque accounts appear free to their holders. Consumers are not charged when they use a debit card in a store or online, but retailers pay a small transaction fee each time the card is swiped. These fees add up to rather large sums. If retail banking fees are cut by 70% or so, as has been proposed, American banks may lose around $33 billion a year, or about a third of their profits from this part of their business last year, says Sherief Meleis of Novantas, the consultancy.



Prudent but poor households will be the first to suffer. They have free bank accounts that are currently subsidised by richer customers with big savings balances and the financially disorganised who pay penalties for unauthorised overdrafts. Estimates vary, but the new rules may well make about one bank customer in ten unprofitable. Banks may also be tempted to close about one in 20 branches.

Several big banks have already responded by charging customers monthly account fees or asking for minimum balances to be maintained on their accounts. Some customers may not be able to comply and may be forced into using less formal and more costly intermediaries such as cheque-cashing services.

Next to feel the heat will be small regional and community banks, many of which will have to merge with bigger rivals. America still has one of the world's most diverse banking markets, with more than 8,000 banks and nearly 100,000 branches, thanks partly to Depression-era laws in most states which imposed strict limits on how big banks could become. It is ironic, therefore, that the new regulations will probably cut the number of banks in America by about a third over the next few years, increasing the size and systemic threat posed by the country's biggest ones.

But there is one reason to be optimistic: America's market remains open enough to allow for new entrants. Since 1990 regulators have licensed an average of more than 120 banks each year. America's retail market has also opened up to foreign competition. In 2003 only three of America's 20 biggest banks were foreign-owned, with a paltry 2.2% share of deposits. Now the top 20 include six foreign-owned banks, among them TD Bank, HSBC, Santander and BNP Paribas. Their share of the market has doubled. Mr Meleis recalls that when he asked the chief executive of a big American bank a few years ago if he was considering an international expansion, the retort was: "Do you mean like the East Coast?" Now, he says, American bankers have bosses in Toronto, Madrid and London.

New blood and fresh ideas are already invigorating the American market. Santander's model of using small, thinly staffed branches is helping it expand cheaply. Retail firms such as Walmart are picking up customers who might otherwise remain unbanked by offering them prepaid cards. Commerce Bank, which is now owned by Canada's TD Financial, shook up the market with innovations such as staying open late so customers could come in after work. New technology and new ways of using it, such as social networks, will probably also create new banks and models of banking, says Stephen Cheetham, a fund manager at AllianceBernstein. Some are already inserting themselves between incumbent banks and their customers, in effect hijacking the relationship and reducing the value of the banks' consumer franchises. One is Mint, a free internet-based financial planner that lets users put information from several sources onto a single screen and then recommends suitable products.

The vibrancy of America's retail banking market owes something to its fragmentation. Most big retail banks, however, are not particularly spread out. In Britain and much of Europe and Asia many of the biggest retail banks are focused on their home markets. This weakens the case against breaking them up into several smaller ones with the same correlated risks.

A further question is whether there are economies of scale in retail banking that would benefit consumers, providing an argument against breaking banks up. Yet it seems that there are few real cost synergies once banks reach a certain

relatively modest size. Researchers continue to argue about exactly where that threshold lies, not least because retail banking is such a local business. Banks that have many branches in a particular city tend to gain an outsized share of local deposits. Bank branches that have above-average deposits also tend to make above-average profits, and they can often get away with offering less attractive interest rates on deposits and loans without losing market share, according to Novantas. The reason is more psychological than rational. It is that a bank with branches on every corner seems safer than one with only a few, even if the deposits of both are guaranteed by the government.

But in most countries retail banks do not stand alone. In recent years the trend has been towards some form of universal banking, with the same bank providing both retail and investment services. And that has heightened the biggest concern of all: that banks are so systemically important that they cannot be allowed to go under.

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The problems of size

Survival of the fattest

What, if anything, can be done about banks that are too big to fail?

SUPERVISORS THE WORLD over are trying to work out ways of dealing with banks that are too big to fail. The most obvious solution is to chop them up into manageable bits so none is too big or interconnected to be allowed to go. But it is far from perfect. For a start, carving up big banks that operate internationally does not necessarily reduce their risk-on the contrary, their geographical spread may have made them safer. And Spain's troubled savings banks show that when many small banks stumble they can cause as much trouble as one big one. The risks on their books are often concentrated.

However, reducing big banks to manageable proportions could be a question not just of size but also of the scope of activities. In the run-up to the crisis and right through it most big banks converged on some variant of universal banking, combining both retail and investment business. If anything, the shotgun marriages that took place at the height of the crisis accelerated this trend, joining many of America's investment banks with their commercial rivals. This was done for good reasons. Universal banks generally have more stable earnings and lower borrowing costs than specialists in one or the other area of business.

Looking at costs can, however, be deceptive. One reason why universal banks are able to borrow more cheaply than standalone investment banks is cross-subsidisation, which raises two worries. The first is that they are able to channel cheap deposits from their retail businesses into their investment banks. Normally regulators are not concerned with the pricing of internal transfers, but for banks the cost of borrowing is inextricably tied to the riskiness of the loan. If one part of a bank is getting money more cheaply from another part of the business than it would from the money markets, the chances are that the risks involved are not being properly priced.

The second worry about low borrowing costs is that universal banks are less likely to be allowed to fail than pure investment banks. Their lower borrowing costs probably stem partly from an implicit government guarantee. A study by Oliver Wyman found that if British banks were forced to split up their businesses and fund each one as a separate subsidiary, their borrowing costs would rise substantially. Part of that increase would be due to the loss of genuine benefits from risk diversification. The other half, however, would represent the loss of a hidden public subsidy, says a person familiar with the study.

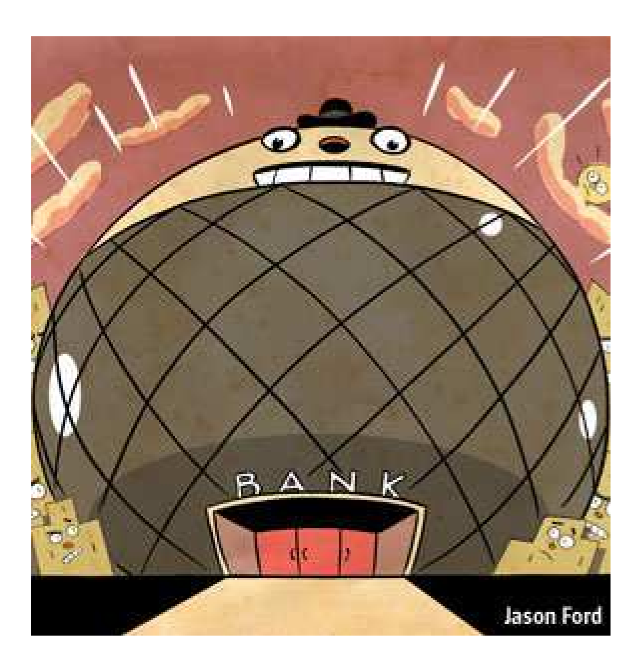
A more rough-and-ready calculation of the public subsidy British banks enjoy, based on the difference between the credit ratings of big and small ones, by Andrew Haldane at the Bank of England, comes up with a much larger sum. Ending these cross-subsidies might make some forms of investment banking more expensive for companies. On the other hand, it should make retail banking cheaper and savers should get slightly higher rates. So cost alone is not necessarily a convincing argument in favour of universal banks.

A better argument is that they offer clients something that others cannot. As companies expand abroad, they want big banks to help them manage their finances across the world. "To the extent that globalisation is alive and well, you will

have global banks," says Vikram Pandit, the chief executive of Citigroup. He has a point. Companies that are able to sweep up cash from disparate subsidiaries every night can significantly cut their use of debt, says Hugo van Wijk of Vallstein, a firm that advises companies on cutting their banking costs. That is important to bank customers, and regulators probably should not tamper with it. But it is a relatively small part of what many global banks do and could well be left alone even if banks had to make other changes to their business.

The really tough decision for regulators is whether the cost of making banks separate out their investment arms is justified by the gains of reduced systemic risk. "I'm against the idea that you solve the problem of a universal bank that is too big to fail by splitting it up," says one senior regulator. "You just end up with an investment bank and a retail bank that are both too big to fail."

In Britain an independent commission on banking thought long and hard about separating investment and retail banks. In a report published last month it suggested that banks should have to fence off their retail arms to insulate them from any failure of their investment arms. Both would have to hold thicker capital cushions. Banks would also have to provide a source of ready funds for a bail-out in the shape of convertible or bail-in capital.



Good resolutions

If chopping up big banks into smaller pieces is not necessarily the answer, at least regulators could make it easier to deal with disasters once they have happened. Small-bank resolution regimes on the whole work well (see article). Could they be adapted for use in rescuing very big banks too?

Since the collapse of Lehman Brothers threw the world economy into turmoil, much has been done to improve the resolution of domestic banks. (Jamie Dimon, the chief executive of J.P. Morgan, objects to the term: "I wish you'd call it minimally damaging bankruptcy for big dumb companies," he says.) Yet regulators confess that they would struggle to extend such arrangements to large and complex banks. "We have a very good resolution regime in this country," says one British official. "But it is a small-bank resolution regime."

Even America's Federal Deposit Insurance Corporation (FDIC), an agency created to maintain stability and public confidence in the nation's financial system, finds it hard to come to grips with this problem. Sheila Bair, its chairman, insists that she has the legal power and the resources to shut down any financial institution, no matter how big. Yet one person who was involved in winding up IndyMac, a Californian lender with $32 billion in assets that wilted in July 2008, reckons that the agency would probably not be able to cope with dismantling anything bigger than that. The failure a few months later of Washington Mutual, an even larger bank, was also managed by the FDIC but substantial parts of its business were passed virtually intact to J.P. Morgan, which had been trying to buy it for months.

One difficulty in dealing with complex banks is their tendency to spawn hundreds or even thousands of subsidiaries. When a bank fails, each subsidiary has to be dealt with separately, which can introduce a lot of complexities. "First you have to figure out which one of the subsidiaries employs the staff," says one person who was involved in the bankruptcy of Lehman. "You can find you've got an organisation with a huge balance sheet but no one actually works for it."

Big international banks are even more difficult to wind up, not least because they are so much more complex than their stay-at-home siblings. A bigger issue, however, is that legal systems and bankruptcy laws have not kept up with the globalisation of finance. Banks are able to whisk money around the world in an instant, and their creditors can withdraw their money in the blink of an eye. This is why bank resolutions must be completed in a single weekend. Yet most bankruptcy laws are geared to the leisurely counting of assets or liabilities in an industrial firm over months, sometimes years. National laws are often incompatible with each other. In Britain, for instance, the courts look at a company's worldwide balance-sheet and apportion what assets they recover to all the creditors of the failed company. By contrast, under American law a failed bank's American depositors are compensated first before any money can be handed out to foreign ones. "Hypothetically it's very simple [to resolve a bank] if you have a hypothetical institution that is established as a single legal entity in one country," says Simon Gleeson of Clifford Chance, a law firm. "As soon as you get into the real world you see that institutional structures are very difficult to deal with."

Politics also intervene. If winding up or bailing out a big cross-border bank, whose taxpayers should be called upon to save it if most of its business is abroad? The problem is particularly acute in Europe, where the single market's rules allow banks to do business freely across borders. Even if countries are worried about the health of a foreign bank that is taking deposits from their citizens, they have little power to stop it from doing so.

One answer would be to draw up an international bank-resolution treaty that would set out how countries should deal with the failure of big cross-border banks. The European Commission is making a start by trying to get members at least to write national laws that do not conflict. But even the most ardent supporters of a global treaty concede that it would take decades to achieve. "I think of this as a trade negotiation," says Mr Kashyap at the University of Chicago. "It's on that sort of scale."

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Better be big

Small banks are more vulnerable to being taken down

THIS FRIDAY EVENING, in all likelihood, federal agents will be quietly checking into hotels under assumed names. Convoys of unmarked cars full of investigators, guards and auditors will start gathering near the branches of three banks across America. In the car boots will be laptop computers, cash-counting machines and pre-printed signs that can be stuck on the windows. At around 5pm local time a few undercover agents will enter the banks and guard the doors. A few will walk straight into the chief executive's office to say that the bank is undercapitalised and is being taken over by the Federal Deposit Insurance Corporation.

The FDIC has had plenty of practice in taking down banks. Last year it closed 157, the year before 140. It is currently keeping a close eye on more than 800 troubled banks. If their capital falls too low, it will step in.

The closures usually happen over a weekend and by the following Monday the banks are reopened under new management. Customers may not even notice. Retail depositors do not lose a penny up to the insurance limit of $250,000 per person. The depositors are paid out of the bank's assets. Rank-and-file employees are asked to help the FDIC sort out the mess and are generally kept on under the new managers. The losers are the bank's owners and its top managers.

This well-oiled machine is the envy of bank supervisors around the world. When Britain's Northern Rock collapsed three years ago the country discovered it had no way of dealing with failing banks apart from nationalising them. Ireland stood behind its banks after the crisis, impoverishing itself in the process, partly because it had no way of separating out deposits and other essential banking utilities from its banks if it allowed them to go broke. Most other European countries found themselves in a similar situation.

Over the past two years just about every rich Western country that did not already have a bankruptcy law for banks has now drafted one. These resolution regimes are designed to let a bank go bust without a slow and potentially destabilising winding-up process that could leave payments systems frozen and depositors without their cash.

Bank ratings provide one indication of their success. When Germany passed a law last year allowing it to wind up banks and inflict losses on their lowest rungs of debt, the prices of these instruments plummeted. Until then, investors had reckoned that the government would rather bail banks out than allow them to fail. In March Moody's gave warning that it might cut the credit ratings of small and medium-sized banks across Europe because they would appear to be less likely to be bailed out. "We have to take at face value the clearly expressed desire to protect taxpayers," says Alastair Wilson, Moody's chief credit officer for the region.

Yet all these measures work only for small, simple and domestic banks. That may seem better than nothing, but it increases banks' incentives to make themselves big enough or complex enough not to be caught by them. The moral hazard here is not so much that a bank's managers will deliberately try to escape the regulator's grasp, but that the creditors of big banks will reward them with lower borrowing costs for being too big to fail.

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After the reforms

Safer, but not yet safe enough

The case for pre-emptive action



BANKING CRISES OF the sort that affect a large part of the world, slowing global economic growth, freezing finance and crimping international trade, are mercifully rare. For most rich countries the crisis of 2008 was the biggest since the Depression that started in 1929. Smaller banking crises of the sort that separately beset America, Britain, Japan and Sweden two or three decades ago are less damaging to the world economy but happen more frequently. The costs of any such meltdowns are difficult to estimate, but when all is said and done the latest one is bound to be judged one of the more expensive. It is not just a question of totting up the direct costs of bailing out the banks or transferring debt from private balance-sheets onto those of the state. There is also the toll of broken lives, lost homes and workers whose skills and confidence have gone after failing to find a job for too long.

Most of the time, though, banks do not blow up. When things go well, they help to produce growth and wealth. They also make people's lives easier. In the rich world this is often overlooked. These days everyone likes to bash bankers. Look at emerging markets, though, and it is clear that people think it is worth paying to send money from one place to another and to keep their savings safe.

Regulators and their political masters now have to ensure that the benefits of a vibrant and innovative banking system are ever more widely spread and meltdowns become ever rarer. Huge strides have been made in trying to re-regulate finance. Banks will soon be holding a lot more capital than they used to, which should make the system safer-though it would be even better if they held even more. Regulators have become bolder, which should also help to reduce the risk of a crisis. Banks themselves are looking at risk in new ways. At least as long as the memories of the latest crisis are fresh, bankers are likely to be more cautious than before.

Yet there are still fundamental flaws in the global financial system. All the measures that regulators are putting in place to try to make banks safer, such as higher capital requirements, stricter regulation and limits on risk-taking, need to be tested against a simple question. If all other safeguards have come to naught, can big financial institutions be allowed to go bust (or be saved without asking taxpayers to stump up)? In the case of Lehman Brothers, the authorities said yes-and precipitated a global financial crisis. It will be years before they feel ready to say yes again. Until they do, big banks that are seen as too important to fail will continue to get cheaper funding than their rivals. This gives them a Darwinian advantage.

Regulators are finding it hard to crack this problem, not through lack of will or imagination but because they are being excessively cautious, seeking certainty before they act. Like a jury in a criminal trial, they are looking for evidence that is beyond reasonable doubt. Yet that overwhelming evidence can never be produced because many of the fundamental questions about banking have no clear or easy answers.

All the same, this report has argued that, on a balance of probabilities, banks that are smaller, more modular and better capitalised are less of a risk to the system than those that are very large and interconnected. These prescriptions are not guaranteed to end banking crises, but they should allow banks to fail more gracefully. There would be costs to making them hold more capital and maintain firewalls between themselves and their neighbours and between their retail arms and investment banks. Yet these costs should not be so prohibitive as to alter the business fundamentally, and will probably be lower than some of the populist regulations now being put in place.

Moreover, these costs should be set against the benefits of lessening the risk of crises that would inflict catastrophic losses. Eliminating that risk altogether is impossible, but if regulators act now while the rules are still malleable, they can make such crises less likely and reduce their harmful effects. Households buy insurance against the possibility that their homes may be struck by lightning. Governments spend vast sums on defence to guard against the remote chance that their countries may be invaded. Yet banking regulators wait for conclusive proof of danger ahead before they act. Until they accept the case for the sort of pre-emptive insurance outlined in this report-tighter regulation, bigger capital cushions, perhaps more separation between different kinds of banking-the clock will continue to tick towards the next financial crisis.

Sources and acknowledgments

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Multinational manufacturers

Moving back to America

The dwindling allure of building factories offshore



"WHEN clients are considering opening another manufacturing plant in China, I've started to urge them to consider alternative locations," says Hal Sirkin of the Boston Consulting Group (BCG). "Have they thought about Vietnam, say? Or maybe [they could] even try Made in USA?" When clients are American firms looking to build factories to serve American customers, Mr Sirkin is increasingly likely to suggest they stay at home, not for patriotic reasons but because the economics of globalisation are changing fast.

Labour arbitrage-taking advantage of lower wages abroad, especially in poor countries-has never been the only force pushing multinationals to locate offshore, but it has certainly played a big part. Now, however, as emerging economies boom, wages there are rising. Pay for factory workers in China, for example, soared by 69% between 2005 and 2010. So the gains from labour arbitrage are starting to shrink, in some cases to the point of irrelevance, according to a new study by BCG.

"Sometime around 2015, manufacturers will be indifferent between locating in America or China for production for consumption in America," says Mr Sirkin. That calculation assumes that wage growth will continue at around 17% a year in China but remain relatively slow in America, and that productivity growth will continue on current trends in both countries. It also assumes a modest appreciation of the yuan against the dollar.

The year 2015 is not far off. Factories take time to build, and can carry on cranking out widgets for years. So firms planning today for production tomorrow are increasingly looking close to home. BCG lists several examples of companies that have already brought plants and jobs back to America. Caterpillar, a maker of vehicles that dig, pull or plough, is shifting some of its excavator production from abroad to Texas. Sauder, an American furniture-maker, is moving production back home from low-wage countries. NCR has returned production of cash machines to Georgia (the

American state, not the country that is occasionally invaded by Russia). Wham-O last year restored half of its Frisbee and Hula Hoop production to America from China and Mexico.

BCG predicts a "manufacturing renaissance" in America. There are reasons to be sceptical. The surge of manufacturing output in the past year or so has largely been about recovering ground lost during the downturn. Moreover, some of the new factories in America have been wooed by subsidies that may soon dry up. But still, the new economics of labour arbitrage will make a difference.

Rather than a stampede of plants coming home, "higher wages in China may cause some firms that were going to scale back in the US to keep their options open by continuing to operate a plant in America," says Gary Pisano of Harvard Business School. The announcement on May 10th by General Motors (GM) that it will invest $2 billion to add up to 4,000 jobs at 17 American plants supports Mr Pisano's point. GM is probably not creating many new jobs but keeping in America jobs that it might otherwise have exported.

Even if wages in China explode, some multinationals will find it hard to bring many jobs back to America, argues Mr Pisano. In some areas, such as consumer electronics, America no longer has the necessary supplier base or infrastructure. Firms did not realise when they shifted operations to low-wage countries that some moves "would be almost irreversible", says Mr Pisano.

Many multinationals will continue to build most of their new factories in emerging markets, not to export stuff back home but because that is where demand is growing fastest. And companies from other rich countries will probably continue to enjoy the opportunity for labour arbitrage for longer than American ones, says Mr Sirkin. Their labour costs are higher than America's and will remain so unless the euro falls sharply against the yuan.

There's no place like home

The opportunity for labour arbitrage is disappearing fastest in basic manufacturing and in China. Other sectors and countries are less affected. As Pankaj Ghemawat, the author of "World 3.0", points out, despite rapidly rising wages in India, its software and back-office offshoring industry is likely to retain its cost advantage for the foreseeable future, not least because of its rapid productivity growth.

Nonetheless, a growing number of multinationals, especially from rich countries, are starting to see the benefits of keeping more of their operations close to home. For many products, labour is a small and diminishing fraction of total costs. And long, complex supply chains turn out to be riskier than many firms realised. When oil prices soar, transport grows dearer. When an epidemic such as SARS hits Asia or when an earthquake hits Japan, supply chains are disrupted. "There has been a definite shortening of supply chains, especially of those that had 30 or 40 processing steps," says Mr Ghemawat.

Firms are also trying to reduce their inventory costs. Importing from China to the United States may require a company to hold 100 days of inventory. That burden can be handily reduced if the goods are made nearer home (though that could be in Mexico rather than in America).

Companies are thinking in more sophisticated ways about their supply chains. Bosses no longer assume that they should always make things in the country with the lowest wages. Increasingly, it makes sense to make things in a variety of places, including America.

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Formula One

Revving up

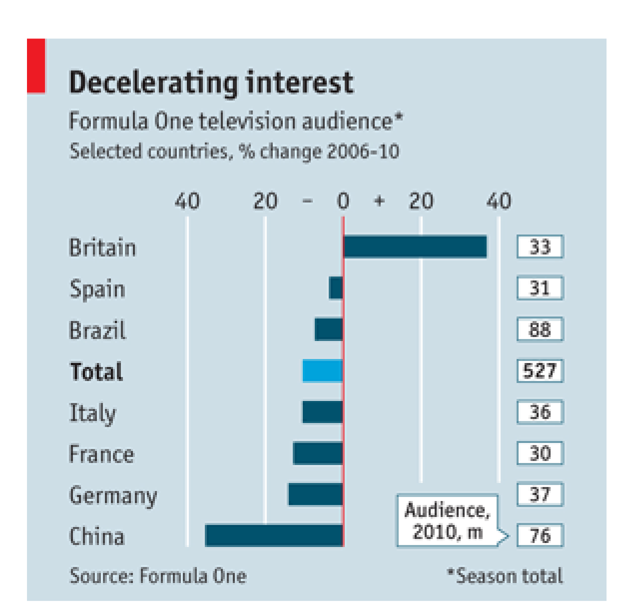
News Corporation and the Agnelli family may buy Formula One



Who's in the driving seat?

FOLLOWING a Grand Prix is tricky. The cars are a blur. Only sharp-eyed spectators can tell which one is winning. An equally confusing race has just begun for the ownership of Formula One itself. On May 3rd News Corporation, a media group, and Exor, the Agnelli family's investment firm, announced that they were developing a plan for the business and might make an offer to CVC Capital Partners, the private-equity firm that owns it.

Exor (which owns nearly 5% of *The Economist*) and News Corporation are cutting in at a time of great uncertainty. An agreement which divides Formula One's profits between the commercial-rights holder and the racing teams expires at the end of 2012. Negotiations for the next one start now. The teams currently get half the operating profits before depreciation and amortisation; now they will reportedly demand as much as 80%. Bernie Ecclestone, Formula One's boss, is 80 and has no successor. He is co-operating with a German investigation into whether a bribe was paid to an executive at Bayerische Landesbank, which in 2005 agreed to sell a stake in Formula One to CVC Capital. He denies knowledge of any wrongdoing.



Formula One's business has decelerated sharply under private-equity ownership. The number of people who watch the sport on television has dropped by a tenth since 2006 (see chart). Annual ticket sales have fallen by over 15% from 3.7m in 2006 to 3.2m in 2010, according to Christian Sylt, author of Formula Money, a financial report, partly due to higher prices. Formula One fans are getting older. The sport has made little effort to woo the young. It relies on its big advertisers, such as Santander, Vodafone and LG, to market its races indirectly, spending little itself to promote the sport. America's NASCAR, in contrast, spends heavily on marketing.

Mr Ecclestone has kept money flowing in by taking Formula One into new markets in Asia and the Middle East where governments are ready to pay steep fees to hold Grand Prix races. Race-hosting fees are now the sport's biggest source of

revenue, taking over from the sale of television rights. Some people close to the sport question whether this is sustainable. Because of the high fees, which go up every year, more circuits than ever are losing money. Some countries are risky: Formula One will lose a packet from the cancellation of its race in Bahrain in March. Although a shift to the east makes sense, it risks eroding the traditional core of fans in Europe, says Xander Heijnen, a consultant. France, where the first Grand Prix was held, no longer has a race after the local organiser decided it was too expensive.

A change of strategy may be required, but News Corp and Exor face hurdles in their pursuit of Formula One. Exor indirectly owns Ferrari, the sport's star team, so it could find it hard to win the backing of rival teams. News Corp operates in pay-television, whereas Formula One is currently broadcast on free-to-air TV; a shift would probably be complicated. Some people close to the sport, including Mr Ecclestone, say the two firms may have some other agenda. Could they lure teams away to form a new, rival Formula One, as Ferrari and other manufacturers have threatened to do in the past? Prepare for some wheel-to-wheel action.

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Mexican cinemas in India

Once upon a time in the east

A Latin American giant plans to modernise India's fleapits



India's drive-in cinemas need sprucing up

NO COUNTRY is as addicted to the silver screen as India. Every year its cinemas shift more than 3 billion tickets, well over double the quantity sold in America, the next-biggest market. But despite its size, the cheap and cheerful Indian box office doesn't make much money: takings are less than $2 billion per year, about the same as those in France, which handles one-twentieth as many admissions.

Tickets are cheap because Indian cinemas are often fleapits. Most have only one screen. Just over 1,000 screens out of about 12,000 are in modern, pricier multiplexes. Swanky new cinemas are going up, but slowly: no more than 300 new screens a year, compared with 2,500 in China.

Now, from the other side of the world, comes a plan to fast-forward India's cinematic development. Cinepolis, a family firm from Michoacan, has gobbled up 60% of the Mexican market and marched into eight other countries in Latin America, making it the fourth-biggest cinema chain in the world. Multiplexes in shopping malls are its speciality: thanks in large part to Cinepolis, Mexico claims one of the world's most modern cinema infrastructures, with eight out of ten screens in big multiplexes.

The men from Michoacan now aim to pull off the same trick in India. In the past 18 months Cinepolis has opened three multiplexes there, introducing gimmicks such as 3D to regions that had never seen such a thing. Another 43 screens are due to open this year, followed by nearly 100 next year and slightly more the year after. The plans include 14- and 15-screen "megaplexes" in Mumbai and Pune, which will be India's largest. The company hopes to have 500 screens by 2016, which could make it the biggest player in the country's fragmented market.

Putting those plans into action is easier said than done. "Everything takes about a year longer than they told you, or more," says Alejandro Ramirez, a former World Bank economist who has inherited control of the family firm. Most of the 43 screens he is opening this year were supposed to open last year. Complex planning laws are partly to blame. So too is the lack of space in India's jam-packed city centres, which means shopping malls grow tall and thin, limiting scope for giant multiplexes. Rents as a proportion of sales are 10 percentage points higher in India than in Latin America, Mr Ramirez says.

India's cinema business is also fiendishly complex for outsiders. Non-English-language films account for 90% of takings, by far the highest proportion in the world (and the opposite of Mexico, where nine out of ten hits are from Hollywood). Even the local market is multilingual. Indian states levy their own entertainment taxes, which run as high as 60%, and some cap ticket prices. Many of the big cinema operators also produce films, something that is rare in Latin America (and illegal, on competition grounds, in the United States). The culture-shock is mutual: "As exotic as India is to us, a Mexican business is exotic to India," Mr Ramirez says. Cinepolis has flown Indian mall developers to Mexico to see its cinemas in action.

But India and Mexico have more in common than a taste for spiced popcorn. India's growing young middle class bears a close resemblance to the Mexican yuppies who pack Cinepolis's range of "VIP" cinemas, which come with reclining seats and sushi-bearing waiters. (The VIP brand will open in Mangalore and Mumbai this year, as well as southern California, marking the firm's first foray into the United States.) Indian vices such as loose contracts and flexible deadlines are not unknown in Latin America. Mr Ramirez says that Cinepolis's experience in nine other emerging markets, including gigantic, Portuguese-speaking Brazil, has made it nimble at adapting to local differences.

If the Mexicans make good on their promises, "it could be a catalyst for the Indian market to grow in the way that people have been predicting for years," says David Hancock, head of cinema at Screen Digest, a consultancy. He cautions that plenty of Indian companies have made similarly ambitious plans, only to get bogged down. Nonetheless, if just a fraction of those 3 billion ticket sales can be diverted from cheap fleapits into pricier multiplexes, blockbuster returns await.

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Water technology

Striking the stone

Israeli firms offer technology to slake the world's thirst

MOSES parted the waters. Strauss aims merely to separate the waters from their yucky impurities. On May 18th in Shanghai Israel's second-largest food and drinks firm will launch a high-tech purifier that not only filters water but also heats it to exactly the right temperature for making tea. Strauss has forged a joint venture with China's Haier Group, the world's biggest maker of white goods, to distribute it.

China is the perfect first market for such an appliance, says Rami Ronen, the boss of Strauss's water arm. Chinese people drink a lot of tea, and their taps emit a lot of undrinkable gunge. At 4,490 yuan ($692) a pop the device is not cheap, but Chinese wallets are increasingly capacious.

Israel wants to become the Silicon Valley of water technology. The conditions are ripe: the country has plenty of scientists, an entrepreneurial culture and a desperate shortage of fresh water. Netafim, one of the world's biggest "blue-tech" firms, got its start on a kibbutz in the Negev desert. Intrigued by an unusually large tree, an agronomist discovered that a cracked

pipe fed droplets directly to its roots. After much experimentation the firm was founded in 1965 to sell what has become known as drip irrigation. Today it boasts annual sales of over $600m and a global workforce of 2,800.

In 2006 the Israeli government launched a programme to support water companies, for instance by helping them to market their products abroad. It also created (and later privatised) Kinrot Ventures, the world's only start-up incubator specialising in water technologies.

A new crop of water-tech firms is emerging, many of them started by computer-industry veterans. "I wanted to invent more than just a new ringtone," says Elad Frenkel, the boss of Aqwise, a firm that provides gear and expertise to build wastewater treatment plants. Facilities based on the firm's technologies feature what it calls "biomass carriers", thimble-sized plastic structures with a large surface area. In wastewater pools they give bacteria more space to grow and thus allow biological contaminants to be consumed more quickly.

Emefcy, a start-up, is also in the wastewater business. It aims to reduce the energy required to clean water, which currently gobbles up 2% of the world's power-generating capacity. One of its products uses special "electrogenic" bacteria to turn wastewater pools into batteries of sorts. If they work as planned, they could generate more electricity than is needed to treat the wastewater.

The mission of TaKaDu, another start-up, is to discover leaks in a water-supply network, sometimes before they happen. It does this by sifting through the data generated by the network's sensors to look for anomalies. Even a 1% change in flow rate, if persistent, can point to a leak. TaKaDu's detection engine is now monitoring water-supply systems in a dozen places, including London and Jerusalem.

Israel still has far to go, however, before it can truly call itself the Silicon Valley for water. Its domestic market is small. Its neighbours, though also desperate for water, are for some reason reluctant to seek help from Israelis. Elsewhere in the world, competition is stiff. Singapore also wants to be a water-tech hub. In developing economies, local players are strong and margins thin. And in America, water is often underpriced and sometimes not even metered.

The Silicon Valley model may not fit the water industry. Venture capitalists are always in a hurry, but water markets are cautious. "You can have bugs in a piece of software, but no bacteria in a water system," says Jonathan Kolodny of McKinsey, a consultancy. Yet the environment is growing more favourable, says Ori Yogev, the chairman of White Water, whose products monitor water quality. Thanks to new rules as well as privatisation, water utilities are more open to new ideas. This is good news, says Amir Peleg, the chief executive of TaKaDu. "It's not the water that is scarce, but innovation."

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South Korean entrepreneurs

Young, gifted and blocked

Korea needs fewer wage slaves and more entrepreneurs

EARLIER this year Humax, a maker of digital set-top boxes based in Seoul, announced that its annual revenues had exceeded 1 trillion won ($865m) for the first time. For South Korea, this is something of a milestone. Humax is a classic start-up, founded in 1989 after a chat between engineering students in a bar. Alas, scandalously few Korean start-ups grow this big.

The Korean economy is dominated by the *chaebol*, huge conglomerates with tentacles in every stew. The biggest, Samsung, accounts for around a fifth of the country's exports. Although the *chaebol* have played a vital role in South Korea's development, they also suck up credit and obstruct the rise of start-ups. "Everyone knows you don't compete with the *chaebol*" is a commonly heard refrain.

Parents of bright young Koreans typically steer them into steady careers in the *chaebol*, the government or the professions. As in Japan, being a salaryman (or woman) is far more respectable than running one's own firm. "In Korea, stability is everything," says one such parent.

Widespread youth unemployment is changing that calculation, however. An impressive 58% of Koreans aged 25-34 have attended university, but 346,000 graduates are currently out of work, up from 268,000 two years ago. Some become entrepreneurs out of necessity: almost 30,000 young South Koreans say they want to launch their own companies, one survey found. And according to the government, the number of "one-man creative enterprises" in the country has risen by 15% in the past year, to 235,000.

Young entrepreneurs often favour tech fields such as social media or gaming, where the only barrier to entry is the power of your imagination. Challenging the *chaebol* at, say, shipbuilding, might be trickier. The previous wave of young entrepreneurs-a result of the first internet boom, and the unemployment that followed the 1997-98 Asian financial crisis-threw up fizzy firms such as NHN, the operator of Naver (the "Korean Google"), and NCsoft, a maker of multiplayer online role-playing games. Each was once tiny but now belongs to the trillion-won club.

These new entrepreneurs are being joined by a growing band of foreigners, including ethnic Koreans from Western countries. Californian Koreans see no stigma in starting your own business. And they see South Korea, where the economy grew by 6.2% last year, as a land of opportunity compared with sluggish America. The country issues about 35,000 investor visas a year, mostly to small-scale entrepreneurs. The Seoul Metropolitan Government's Global Centre has recently been swamped by expats seeking to attend its classes on Korean business procedures and regulations.

The city has also launched a "Youth 1,000 CEO Project", to provide young entrepreneurs with free office space and grants of up to 1m won per month. South Korea's President Lee Myung-bak grumbles that Korea has no Mark Zuckerberg (the baby-faced founder of Facebook).

The problem, though, is not young Koreans, who are both bright and energetic. Nor is it business-throttling regulations: South Korea does better on that score than Japan or Taiwan, says the World Bank. The real obstacle to enterprise is a society that urges its best young minds to aim low.

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Selling music companies

Siren song

No one wants to pay for music. Yet investors are splurging on music firms



And you thought Cher was extravagant

SAY what you like about the men who built business empires from the wreckage of Soviet communism. To money-losing Western outfits, they are angels. Roman Abramovich turned Chelsea football club into a winner. Alexander Lebedev rescued the *Evening Standard* and *Independent* newspapers. And on May 6th Len Blavatnik, an oil magnate, agreed to pay $3.3 billion for Warner Music Group. The stunned reaction among music executives suggests that his is the greatest act of charity yet.

Warner Music was born in 2003, when Edgar Bronfman and a group of investors paid $2.6 billion for Time Warner's music division. Mr Bronfman, heir to a whisky fortune, was known as an unlucky investor. *New York* magazine called him "possibly the stupidest person in the media business". Not any more. He has managed to sell a company in a collapsing industry for substantially more than it cost (and there are rumours that another suitor will yet try to trump Mr Blavatnik's offer). It is like making a killing on a buggy-whip firm in the car-crazy 1920s.

Since 2003 global CD sales have roughly halved. Competition from pirates has crushed retailers and forced record labels to cut prices. Rising digital music sales, mostly through Apple's iTunes store, have not nearly made up for these losses. And it is still unclear whether music-streaming outfits such as Spotify will reverse the decline or accelerate it by drawing honest people away from buying music.

Under Mr Bronfman and his private-equity partners, Warner Music drastically pruned costs in the mid-2000s. Executives went from flying first class to business class, then to economy. For a while revenues held up, suggesting it was possible to run a successful music firm on the cheap. But since 2008 Warner's recorded-music sales have dropped by 15%. Its "artist and repertoire" costs, which include scouting and signing artists, are also dropping. That is a worrying sign, akin to a drug firm spending less on R&D.

Investors argue that music publishing (that is, the trade in songs rather than recorded music) is still flush. This is true. Advertisers and TV broadcasters are hooked on music, and that brings money to record labels. But firms must cultivate songwriters for years. Warner's publishing business is weak-its share of the market has slipped in the past two years to 13.9%, according to *Music & Copyright*, a trade publication. The accident-prone EMI has done better.

The scuttlebutt now is that Warner will try to buy EMI from Citigroup, which seized it earlier this year from Terra Firma, another private-equity firm. That would make some sense. Warner is strong in America; EMI is strong in Europe. And rich technology firms want to emulate Apple by building businesses on music: Google launched a music-storage service on May 10th. The bigger the music firm, the more it can pick winners and steer the digital market. A merged EMI-Warner would be a serious rival to Universal Music Group, the world's biggest music company.

Overpaying for two music firms is thus not twice as crazy as overpaying for one. But Mr Blavatnik may not get the chance. A merger between EMI and Warner Music has been stymied by regulators before, and Citigroup may not have the

patience for endless wrangling. Also, the brisk auction for Warner Music suggests there will be no shortage of rich men willing to lose-sorry, risk-money on a record company.

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Schumpeter

Rules for fools

The terrible threat of unlicensed interior designers



IN 1941 Franklin Roosevelt added two new items to America's ancestral freedoms of speech and worship: freedom from fear and freedom from want. Today's politicians offer a far more generous menu: freedom from unlicensed hair-cutters, freedom from cowboy flower-arrangers and, most important of all, freedom from rogue interior designers. What is the point of enjoying freedom from fear or want, after all, if you cannot enjoy freedom from poorly co-ordinated colour schemes?

In the 1950s, when organisation man ruled, fewer than 5% of American workers needed licences. Today, after three decades of deregulation, the figure is almost 30%. Add to that people who are preparing to obtain a licence or whose jobs involve some form of certification and the share is 38%. Other rich countries impose far fewer fetters than the land of the free. In Britain only 13% of workers need licences (though that has doubled in 12 years).

Some occupations clearly need to be licensed. Nobody wants to unleash amateur doctors and dentists on the public, or untrained tattoo artists for that matter. But, as the *Wall Street Journal* has doggedly pointed out, America's Licence Raj has extended its tentacles into occupations that pose no plausible threat to health or safety-occupations, moreover, that are governed by considerations of taste rather than anything that can be objectively measured by licensing authorities. The list of jobs that require licences in some states already sounds like something from Monty Python-florists, handymen, wrestlers, tour guides, frozen-dessert sellers, firework operatives, second-hand booksellers and, of course, interior designers-but it will become sillier still if ambitious cat-groomers and dog-walkers get their way.

Getting a licence can be time-consuming. Want to become a barber in California? That will require studying the art of cutting and blow-drying for almost a year. Want to work in the wig trade in Texas? You will need to take 300 hours of classes and pass both written and practical exams. Alabama obliges manicurists to sit through 750 hours of instruction before taking a practical exam. Florida will not let you work as an interior designer unless you complete a four-year university degree and a two-year apprenticeship and pass a two-day examination.

America's Licence Raj crushes would-be entrepreneurs. Consider three people who come from very different states and occupations. Jestina Clayton is an African hair-braider with 23 years of experience. But the Utah Barber, Cosmetologist/Barber, Esthetician, Electrologist and Nail Technician Licensing Board told her that she cannot practise her craft unless she first obtains a licence-which means spending up to $18,000 on 2,000 hours of study, none of it devoted to African hair-braiding.

Justin Brown is an abbot at a Benedictine abbey that supplements its meagre income by making and selling simple wooden coffins. But the Louisiana Board of Embalmers and Funeral Directors has ordered him to "cease and desist". Heaven knows what harm a corpse might suffer from an unlicensed coffin. Barbara Vanderkolk Gardner runs a flourishing interior-design business in New Jersey. But when she tried to expand into Florida, the state's Board of Architecture and Interior Design ordered her to delete all references to "interior design" from her website and stop offering "interior design services" in the Sunshine State.

The cost of all this pettifoggery is huge-unless, that is, you are a member of one of the cartels that pushes for pettifogging rules or an employee of one of the bureaucratic bodies charged with enforcing them. Morris Kleiner of the University of Minnesota calculates that licensing boosts the income of licensees by about 15%. In other words, it has about the same impact on wages as membership of a trade union does. (Trade unionists who are also protected by licences enjoy a 24% boost to their hourly wages.) Mr Kleiner also argues that licensing slows job-creation: by comparing occupations that are regulated in some states but not in others he found that job growth between 1990 and 2000 was 20% higher in unregulated occupations than in regulated ones.

The Institute for Justice, a free-market pressure group, argues that this is only the beginning of the Raj's sins. The patchwork of regulations makes it hard for people to move from state to state. The burden of regulations falls most heavily on ethnic minorities (who are less likely to have educational qualifications) and on women (who might want to return to work after raising their children). States that demand that funeral directors must also qualify as embalmers, for example, have 24% fewer female funeral directors than those that don't.

Uncle Sam will save you from bad feng shui

You might imagine that Americans would be up in arms about all this. After all, the Licence Raj embodies the two things that Americans are supposed to be furious about: the rise of big government and the stalling of America's job-creating machine. You would be wrong. Florida's legislature recently debated a bill to remove licensing requirements from 20 occupations, including hair-braiding, interior design and teaching ballroom-dancing. For a while it looked as if the bill would sail through: Florida has been a centre of tea-party agitation and both chambers have Republican majorities. But the people who care most about this issue-the cartels of incumbents-lobbied the loudest. One predicted that unlicensed designers would use fabrics that might spread disease and cause 88,000 deaths a year. Another suggested, even more alarmingly, that clashing colour schemes might adversely affect "salivation". In the early hours of May 7th the bill was defeated. If Republican majorities cannot pluck up the courage to challenge a cartel of interior designers when Florida's unemployment rate is more than 10%, what hope has America? The Licence Raj may be here to stay.

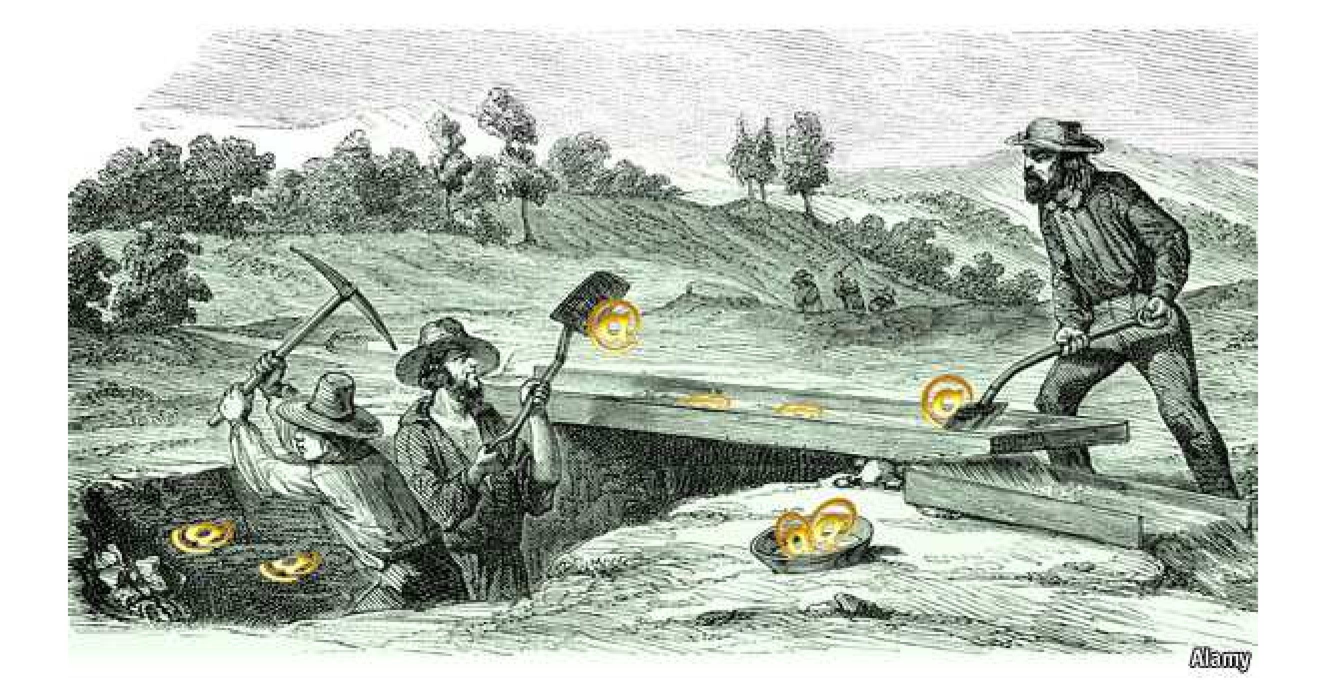
Economist.com/blogs/schumpeter

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Internet businesses

Another digital gold rush

Internet companies are booming again. Does that mean it is time to buy or to sell?



PIER 38 is a vast, hangar-like structure, perched on San Francisco's waterfront. Once a place where Chinese immigrants landed with picks and shovels, ready to build railways during California's Gold Rush, the pier is now home to a host of entrepreneurs with smartphones and computers engaged in a race for internet riches. From their open-plan offices, the young people running start-ups with fashionably odd names such as NoiseToys, Adility and Trazzler can gaze at the fancy yachts moored nearby when they aren't furiously tapping out lines of code.

"The speed of innovation is unlike anything we've seen before," says Ryan Spoon, who runs Dogpatch Labs, an arm of a venture-capital firm that rents space to young companies at Pier 38. Like many other entrepreneurs, the tenants would love to follow firms such as Facebook and Zynga, a maker of hugely popular online games including Farmville, that have been thrust into the internet limelight in the space of a few short years.

Some of the most prominent start-ups are preparing for stockmarket listings or are being bought by big firms with deep pockets. On May 9th LinkedIn, a social network for professionals that took in revenue of $243m last year, set the terms of its imminent initial public offering (IPO) on the New York Stock Exchange (NYSE), which value it at up to $3.3 billion. The next day Microsoft said it was buying Skype, an internet calling and video service, for $8.5 billion (see article).

Other firms such as Groupon, which provides online coupons to its subscribers, are likely to go public soon. The return of big internet IPOs, rarities since a bubble in telecoms and internet stocks burst in 2000, and the resurgence of large mergers and acquisitions among technology firms is dividing opinion in the industry. Some veterans see a new bubble forming in the valuations of start-ups and a handful of more mature firms such as Twitter, which is still hunting for a satisfactory business model five years after the first tweet. More sanguine voices retort that many young companies have exciting prospects and that there are plenty of corporate buyers, such as Microsoft, with the money and confidence to snap up older internet firms still in private hands.

Technology, finance and China

Yet both sides agree that the internet world is being transformed by a number of powerful forces, three of which stand out. First, technological progress has made it much simpler and cheaper to try out myriad bright ideas for online businesses. Second, a new breed of rich investors has been keen to back those ideas. And, third, this boom is much more global than the last one; Chinese internet firms are causing as much excitement as American ones.

Start with technology. Moore's law, which holds that the number of transistors that can be put on a single computer chip doubles roughly every 18 months, has continued to work its magic, leading to the proliferation of ever more capable and affordable consumer devices. Some of today's tablet computers and smartphones are more powerful than personal computers were a decade ago. IDC, a research firm, estimates that around 450m smartphones will be shipped worldwide this year, up from 303m in 2010.

Moore's law also underpins the growth of "cloud" services, such as Apple's iTunes music store, which can be reached from almost any device, almost anywhere. Such services are hosted in data centres, the factories of the cloud, which are

crammed with hundreds of thousands of servers, whose price has plunged as their processing power has soared. Everything is connected ever faster, with ever fewer wires.

These technological trends have given rise to new "platforms"-computing bases on which other companies can build services. Examples include operating systems for smartphones and social networks such as Facebook and LinkedIn. Some of them are used by hundreds of millions of people. And the platforms are generating oceans of data from smartphones, sensors and other devices.

These platforms are vast spaces of digital opportunity. Perhaps the most striking example of the innovation they have sparked is the outpouring of downloadable software applications, or "apps", for smartphones and computers. Apple's App Store, a mere three years old, offers more than 300,000 of them. Users of Facebook are installing them at a rate of 20m a day. Services such as Skype have also benefited from the spread of smart devices and lightning-fast connectivity.

Some excited people have likened this technological upheaval to the Cambrian explosion 500m years ago, when evolution on Earth speeded up in part because the cell had been perfected and standardised. They may be exaggerating. Even so, creating a web firm has become much easier. By tapping into cheap cloud-computing capacity and by using platforms to reach millions of potential customers, a company can be up and running for thousands of dollars rather than the millions needed in the 1990s.

Guardian angels

Thanks to the boom's second driving force, finance, these companies have no shortage of eager backers. Although too small to interest many venture-capital firms, they are being fought over by wealthy individual investors, or "angels" in the venture industry's jargon. Many of these financiers made their fortunes during the 1990s bubble and are eager to put their know-how and cash behind today's tiny companies.

Some "super angels", such as Aydin Senkut, a former Google employee who runs Felicis Ventures, and Mike Maples, a software entrepreneur who oversees a firm called Floodgate, are occasionally making bets comparable to those of conventional venture funds, which gather and invest money from a wide range of institutional investors. Individual investments of up to $1m are not uncommon. Sometimes angels are clubbing together to provide young firms with even larger sums.

Their cumulative impact is staggering. According to the Centre for Venture Research at the University of New Hampshire, angel investors in America pumped about $20 billion into young firms last year, up from $17.6 billion in 2009. That is not far off the $22 billion that America's National Venture Capital Association says its members invested in 2010. Much of the angels' money has gone to consumer-internet firms and makers of software apps.

The financing of more mature tech start-ups has also changed. Elite venture-capital firms such as Andreessen Horowitz and Kleiner Perkins Caufield & Byers have raised billions of dollars in new funds in the past year or so. Some of this money has been pumped into "late-stage" investments (eg, in Twitter and Skype), allowing companies to remain private and independent for longer than used to be the norm.

Venture firms are not the only ones with internet companies in their sights. Some would argue that it was DST, a Russian holding company now renamed Mail.ru, and a related investment fund, DST Global, that set off the boom. In 2009, when most investors in America were sitting on their hands, both poured hundreds of millions of dollars into fast-growing prospects there such as Facebook and Groupon. Those investments seem likely to pay off handsomely.

American hedge funds, private-equity firms and even some mutual funds have followed, falling over one another in pursuit of the shares of popular internet companies. Investment banks including Goldman Sachs and JPMorgan Chase have also set up funds to help rich clients buy stakes.



Their task has been made easier by the advent of secondary markets in America, such as SharesPost and SecondMarket, that allow professional investors to trade the equity of private companies more efficiently. They have also made it simpler for employees and angel investors to offload some shares-and have enabled the world at large to observe a remarkable rise in valuations (see chart 1).

American consumer-internet companies have not been the only beneficiaries of this flood of cash. The boom's third driving force is the rapid globalisation of the industry. Europe, which has at long last developed an entrepreneurial ecosystem worthy of the name, is home to several impressive firms. These include Spotify, an Anglo-Swedish music-streaming service with more than 10m registered users, and Vente Privee, a French clothing discounter with annual revenue of some $1 billion.

Much more striking, however, is that the latest round of euphoria involves emerging markets that were mere spectators during the last one, above all China. The country boasts not only the world's biggest online population, but also its fastest-growing. The number of internet users there will rise from 457m last year to more than 700m in 2015, according to the Boston Consulting Group (BCG). And the Chinese are no longer mostly playing games, but are diving into lots of other online activities, notably shopping. Between 2010 and 2015, predicts BCG, China's e-commerce market will more than quadruple, from $71 billion to $305 billion-which could make it the world's largest.

Such forecasts have stimulated plenty of venture capital, both foreign and domestic. Albeit with a dip in 2009, the amount raised by Chinese venture funds has grown sharply, rising from nearly $4 billion in 2006 to more than $11 billion in 2010 according to Zero2IPO, a research firm. The sum invested increased from $1.8 billion to nearly $5.4 billion. Much of this went into internet start-ups.

The Eastern gold rush

Listed Chinese internet companies

	Business	Market cap May 9th 2011, $bn	Q1 2011*, $m Revenues	Net profit/loss	Market position
Baidu	Paid search	49.7	372.0	163.5	75.8% share in search
Tencent	Instant messaging, online games	49.6	966.8	437.8	648m instant-messaging accounts
Alibaba	B2B e-commerce	8.9	228.6	61.7	61m registered users
Sina	Portal, micro-blogging	7.7	110.0	-100.0	95m registered users
Ctrip	Travel	6.6	119.3	45.8	2m hotel rooms booked monthly
NetEase	Online games, portal	6.2	247.5	108.0	640m daily page views
Youku	Online video	5.8	19.5	-7.2	281m monthly unique visitors
Renren	Social networking	5.8	20.6	-2.6	113m registered users
Sohu	Portal, paid search, online games	3.6	174.4	44.8	116.5m games players
Qihoo 360	Anti-virus software	3.2	19.8	4.0	339m monthly active users
Dangdang	B2C e-commerce	1.8	107.7	2.2	4.4m monthly active customers

Sources: Company reports; Bloomberg

*Or latest

Investors have also been desperate for shares in Chinese companies listed on American stock exchanges (see table). Since the start of the year the share prices of the biggest of these firms have risen by more than a third, according to iChina Stock, a website. Baidu, China's largest search engine, has seen its share price climb from about $60 to $150 in the past 12 months, taking its market capitalisation to nearly $50 billion. Tencent, which makes most of its money from online games, is worth about the same. Both are among the world's top five internet firms by stockmarket value. The ten biggest Chinese companies have a combined worth of $150 billion, not much less than Google's.

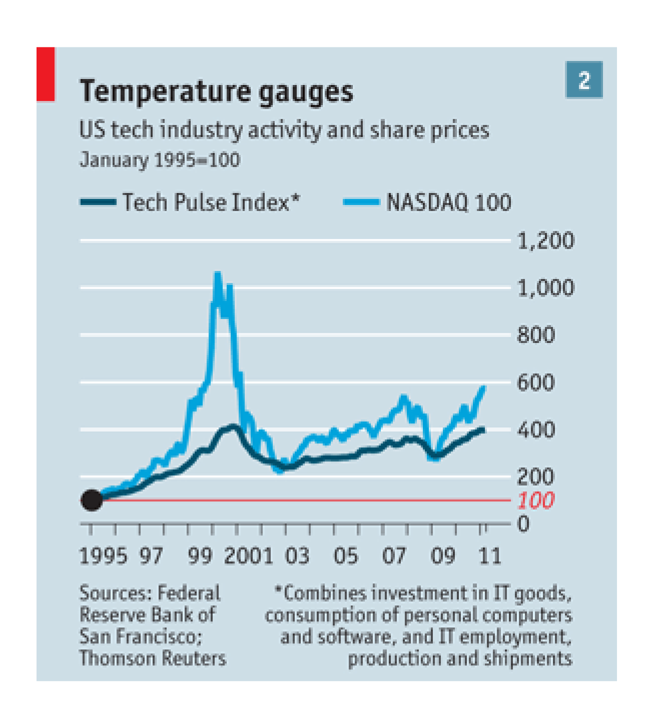
They tend to sparkle on their debuts. When Youku, China's largest online-video company, listed its shares on December 8th its stock jumped by 161%, the biggest gain by a newcomer to the NYSE for five years. The share price of Dangdang, an online retailer floated on the same day, almost doubled. And on May 4th Renren, a social network, saw its share price rise by 29% on the first day of trading, though it has fallen back almost to where it started.

The experience of Chinese firms in America has encouraged other emerging-market internet companies to consider IPOs there. On the day LinkedIn revealed the terms of its offering, Yandex, a Russian search engine, said it would soon raise $1.1 billion by listing its shares on the tech-heavy NASDAQ stockmarket.

Those who think that talk of a new tech bubble is misleading point out that firms such as LinkedIn and Renren have proven business models and healthy revenues. Many internet firms that went public in the late 1990s could not say the same. Moreover, the price-earnings multiples at which other public companies in the technology sector are trading are nowhere near as frothy as they were before the last bubble burst in 2000. That should limit excesses in valuing private firms.

Bubble in the making?

This has led some venture capitalists to argue that 2011 may be more like 1995 than 1999: if a bubble is inflating, it is a long way from popping. So investors who shun internet firms now may be missing a great chance to mint money. Jeffrey Bussgang of Flybridge Capital Partners, a venture firm, notes that venture funds raised between 1995 and 1997 enjoyed stellar returns.



Others point to signs of bubbliness. For instance, some start-up firms are dangling multi-million-dollar pay packages in order to tempt star programmers from Google, Microsoft and other big companies. They are chasing scarce skills when the broader technology industry is on a roll. The NASDAQ index may be far below the heights of March 2000, but it has bounced back from the global downturn; and the Federal Reserve Bank of San Francisco's Tech Pulse Index, which measures the vibrancy of America's tech industry, is near its peak of 11 years ago (see chart 2).

There are also signs of irrational exuberance among some investors. Color, a photo-sharing and social-networking start-up, has been reportedly valued at around $100m by venture firms, even though it has an untested product in a crowded market. Competition among angel investors has helped drive up valuations of social-media start-ups by more than 50% in the past 12 months. Financiers are sometimes skimping on due diligence in the scramble to win deals. In China, too, the purported

worth of young firms has risen breathtakingly fast-to an average of $15m-20m in first-round venture financings, which is expensive even by Silicon Valley's standards.

The danger in all this is that investors lose sight of the risks to the value of internet companies. These are greatest in China. Competition there is intense and users are fickle. Moreover, Chinese firms must wrestle with thorny regulatory and political issues. The government has yet to shut down a listed web company and firms are usually masters of self-censorship. But any move against them could have broad repercussions for all Chinese internet stocks.

European and American internet start-ups do not face a similar threat. But they are still vulnerable to inflated expectations. "Every bubble is a game of musical chairs," says Steve Blank, a former serial entrepreneur who teaches at Stanford. The trick is to sell or float companies just before the music stops and the bubble bursts. If some of the hopefuls of Pier 38 can do just that, they may one day be able to afford a yacht or two of their own.

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Microsoft's gamble

A big phone bill

The price that Microsoft is paying for Skype looks high

STEVE BALLMER was his usual effervescent self on stage at a press conference in San Francisco this week. Announcing an $8.5 billion purchase of Skype, an internet calling and video service, the boss of Microsoft kept boasting about how "super-ambitious" his company is. The firm's largest-ever acquisition is proof that Microsoft is indeed willing to place big bets on what it considers to be revolutionary technologies. It also represents a significant victory for some bold technology investors.

Much ink has been spilled on the subject of Skype's price tag, 400 times the company's 2010 operating profit. Microsoft claims that this lofty sum is justified because Skype can leverage its new parent's various platforms, including the Windows Phone 7 mobile operating system and the Xbox gaming platform, to create exciting new services for the 170m customers that use it regularly. It can also take advantage of Microsoft's substantial presence in the world of corporate computing to win more business there. Microsoft says it will fit neatly with its popular Lync offering, which combines various communications tools such as video chatting and web conferencing in a single package.

Mr Ballmer sees other opportunities to boost Skype's revenues, which hit $860m last year-in particular by helping it to sign up many more online advertisers. The snag with this is that people engrossed in video chatting may well resent being bombarded with ads. And having become accustomed to getting a wonderful service for nothing, they may be reluctant to pay for new products that Skype rolls out unless these are especially compelling.

Some observers think Microsoft may have been motivated by its desire to keep Skype's know-how out of the hands of rivals such as Cisco and Google. Whether or not this is true, there is little doubt that Mr Ballmer was keen to get his hands on the company. Skype was heading for a stockmarket flotation until Microsoft's boss lobbed in an unsolicited offer for it a couple of months ago and then moved quickly to close a deal.

The result has been a windfall for several investors in Skype, including Silver Lake, a private-equity firm, and Andreessen Horowitz, a venture-capital firm set up by Marc Andreessen, a co-founder of Netscape, and Ben Horowitz, with whom Mr Andreessen founded another company. Both outfits have made a habit of buying unusually big stakes in hot private companies that they reckon still have plenty of room to grow.

Some critics have accused the firms of inflating the share prices of large web companies, but their bets on Skype, at least, have paid off. Andreessen Horowitz has quadrupled the initial $50m it invested just 18 months ago when Skype's then owner, eBay, sold a big chunk of its shares. Now other institutions such as hedge funds are piling into the market and hunting for similar opportunities. "The competitive intensity has definitely risen in the big internet brand names," says Mr Andreessen. It is unlikely that all of these super-ambitious investors will end up making super-impressive returns.

Europe's debt saga

Every which way but solved

A bail-out strategy as bankrupt as Greece should be ditched. It probably won't be



IF APRIL is the cruellest month for poets, May is the harshest one for European leaders. A year ago they tore up the rule book to bail out Greece and to ward off market attacks on other fiscal reprobates in the euro area. The first anniversary of the rescue mission has been nothing to celebrate. Despite a year of grinding hardship Greece looks ever more likely to have to restructure its debts. The official rescue funds hastily mustered in May 2010 have had to be deployed twice more since then, first to support Ireland late last year, and now to keep Portugal afloat.

The most pressing concern is Greece. The big hitters in the euro area-in particular Germany and the European Central Bank-are squabbling furiously about how to deal with the country's debt burden. News of a "secret" meeting on May 6th between finance ministers from Greece and its main euro-area creditor states leaked out along with a report that Greece might leave the euro. That claim was strenuously denied. But policymakers seem unable to agree on much else.

The original plan in May 2010 was conceived on the notion that Greece faced an acute but temporary funding problem. A liquidity issue could be addressed by using official lending from the euro area and the IMF of euro110 billion ($157 billion) to replace funding from the markets, which were by then demanding punitive rates. The country would meanwhile take drastic steps to reduce its deficit. That would rebuild investor confidence and allow Greece to return to the bond markets, partially in 2012 and completely by mid-2013.

That schedule now looks hideously overoptimistic. Investors have become even more loth to provide long-term funding: ten-year bond yields now exceed 15%, compared with a peak of 12.3% a year ago. This reflects, in part, an appreciation that Greece's fiscal woes are even graver than they first appeared. The starting-point in 2009 for both debt and the deficit turned out to be worse than realised; tax revenues have proved disappointing as austerity measures have undermined growth. As a result Greek government debt at the end of last year was close to 145% of GDP and the deficit for 2010 was a colossal 10.5% of GDP, well above the original target of 8.1%.

Even the most cohesive and determined government would be hard-pressed to get out of this kind of fiscal mess. Instead, the Socialist government of George Papandreou is split over the prospect of yet more painful reforms. There is talk of installing EU officials at Greek ministries where the most foot-dragging has occurred. The hardest task will be pushing

through a euro50 billion privatisation programme which is openly opposed by Mr Papandreou's closest cabinet allies, Tina Birbili, the environment and energy minister, and Louka Katseli, the labour minister.

If the sovereign-debt crisis had been confined to Greece, it could be treated as a special case that did not threaten the euro area as a whole. But that has been given the lie by the fall of Ireland and Portugal. Each of these economies had particular features that made them vulnerable. In Ireland, unlike Greece and Portugal, a toxic banking system contaminated the state's finances. In Portugal a decade of wretchedly low growth testified to problems afflicting the whole economy.

But when three different countries stumble, the claim of *sui generis* does too. Once safely tucked inside the euro area and benefiting from low interest rates, all three mismanaged their economies and public finances. Greece and Portugal ran huge current-account deficits while Ireland presided over a prodigious property boom that disguised underlying fiscal weaknesses through flaky housing-related revenues. In varying degrees all three lost competitiveness, as measured by unit labour costs compared with Germany's. (Much the same story can be told of Spain's far bigger economy, even though for the moment investors seem to be giving it the benefit of the doubt.)

The original diagnosis of Greece was wrong. Its fiscal malaise was too profound to be sorted out by a bridging loan. The same mistake may well be being made with the bail-outs of Ireland and Portugal: the salve of temporary liquidity support does not necessarily help countries with deeper fiscal weaknesses.

Not before time some European countries are having second thoughts. Behind the scenes Germany has been pushing for Greece to "reprofile" its debt-a soft form of restructuring that would leave principal and coupon payments intact but extend bond maturities. That would not go far enough in tackling Greece's indebtedness but it would relieve other euro-area states of the need to send extra funds to Greece in 2012, and it would also protect banks that hold Greek debt in their books at par from having to take write-downs. But the European Central Bank is adamantly opposed to any form of restructuring; others are nervous, too.

Even though it would be hard to sell to restive northern European electorates, the temptation may be to postpone the inevitable yet again with the drug of more official funds. That might calm markets in the short term. But it would leave European leaders where they have been for most of the past year-struggling to control the situation because the solution of a big haircut on Greece's debt is too unpalatable. Restructuring will be needed, and probably not just in Greece.

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The Galleon trial

Guilty as charged

The verdict is finally in

IN A phone call recorded by the government in 2008 Raj Rajaratnam, the boss of Galleon Group, a large hedge fund, called Danielle Chiesi, an executive at another fund, to thank her for sharing a tip. "But it's a conquest, right?" he asks her. "It's a conquest," she responds. "You're a warrior. I'm a warrior."

On May 11th Mr Rajaratnam lost the battle he was fighting against government prosecutors. He was convicted on 14 counts of securities fraud and conspiracy, and faces many years in prison when he is sentenced in July. A New York jury found that Mr Rajaratnam made nearly $64m from trading based on tips he ferreted out from a network of corporate executives and traders about firms like Goldman Sachs, Google and Intel. He rewarded them generously for confidential information. He paid Anil Kumar, then an executive at McKinsey, $500,000 a year for tips about the firm's clients, for example.

This is the first insider-trading case in which the government has used wiretaps, and they were pivotal in Mr Rajaratnam's conviction. The jury heard dozens of conversations that showed him as foul-mouthed, boastful and conniving. In one Mr Rajaratnam and his brother, Rengan, talk about getting another McKinsey executive to leak information. "Everybody is a scumbag," says Rengan, and they laugh.

Mr Rajaratnam, a risk-taker in his trading, took the same approach to fighting the government's charges against him. He hired a public-relations manager to set up a website, rajdefense.org, which attacked supposedly biased news articles and posted documents relevant to his case. His lawyers argued that the information Mr Rajaratnam traded on was publicly available, pointing to news reports that speculated about upcoming deals and results.

But it proved impossible to distract the jury from what was said in those calls. The defence case also stumbled when Rick Schutte, a former Galleon president who testified that Mr Rajaratnam was just a meticulous researcher, revealed under questioning that Mr Rajaratnam and his family had invested $25m in his new hedge fund.

The trial afforded a glimpse inside what used to be one of the industry's largest and most respected funds. Galleon, which managed $6.5 billion at its peak, gathered staff every morning at a meeting, and employees were fined if they were late. Analysts and portfolio managers had to circulate weekly reports with their best trading ideas. Mr Rajaratnam sat in front of six computer screens during the day. Internal instant messages, e-mails and company documents revealed an intense and competitive culture that blended legitimate research with illegally obtained tips.

Mr Rajaratnam will appeal but if it stands, the conviction is a major victory for emboldened prosecutors, who are making insider trading and market abuse a priority. Enforcement of insider-trading law tends to go up after periods of market stress, according to Laura Beny at the University of Michigan Law School. In the past 18 months, the US Attorney's Office has charged 47 people with insider trading. Mr Rajaratnam is the 35th to be convicted.

"A long-term full-court press to root out insider trading in the hedge-fund business" is how Janice Fedarcyk, an assistant director at the Federal Bureau of Investigation, has described the government's ambitions. Robert Khuzami, director of enforcement at the Securities and Exchange Commission (SEC), says it will target hedge funds for "aberrational" performance, which he considers to be outperforming the market consistently by 3% or more.

Hedge-fund executives, gathering in Las Vegas for an industry event (see article), are not pleased with all the attention they're getting. More headlines are likely. The government has arrested several other hedge-fund managers, including two former portfolio managers at SAC Capital, one of the industry's largest funds, as part of a crackdown on the use of "expert network" firms, which link hedge funds with company executives. Another Galleon employee, Zvi Goffer, who attended Mr Rajaratnam's trial, has been charged with insider trading and will stand trial later this month.

It's not just hedge funds that will feel the fallout from Galleon. The case ensnared executives and board members at companies like McKinsey, Intel, Goldman Sachs, Moody's and IBM. That will lead companies to rethink their insider-trading and compliance policies. The biggest fish to be caught up in the mess so far is Rajat Gupta, a former board member of Goldman Sachs and ex-boss of McKinsey, who has been charged by the SEC in an administrative proceeding for allegedly passing tips to Mr Rajaratnam. Mr Gupta has sued the SEC and is asking to stand trial in front of a jury. He may reconsider now that he has seen Mr Rajaratnam's fate.

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Hedge funds

Power and piÃ±atas

Anthony Scaramucci, hedge-fund ambassador



Scaramucci would do the fandango

MOST hedge-fund managers like to stay out of the spotlight. The guilty verdict handed down in the Galleon trial on May 11th will make many in the industry even more publicity-shy. But Anthony Scaramucci, the boss of SkyBridge, an $8.1 billion fund of hedge funds, relishes it. On May 11th "the Mooch" took the stage to welcome around 1,500 people to the SkyBridge Alternatives (SALT) conference in Las Vegas. In only its third year, the conference has become a sort of Davos for the hedge-fund world, complete with clapped-out politicians as speakers.

Mr Scaramucci, a former Goldman Sachs executive, co-founded SkyBridge in 2005. The firm has expanded quickly: SkyBridge acquired some of Citigroup's hedge-fund units in 2010, which helped it quadruple in size. Mr Scaramucci's ambitions go beyond being a run-of-the-mill Wall Street executive, however. He's appointed himself ambassador-at-large for the hedge-fund industry. "Everyone wants to be veiled up, secret and in the dark," he says. "I'd rather go the opposite way." Last year he turned heads when he accused Barack Obama at a televised town-hall meeting of "whacking" Wall Street "like a piÃ±ata". Mr Obama promptly took a stick to his argument.

Between running SkyBridge and being dressed down by Mr Obama, he found time to serve as adviser to Oliver Stone, a Hollywood director, in "Money Never Sleeps", the sequel to "Wall Street". Ever the negotiator, he ensured that SkyBridge got on-screen publicity as the sponsor of a gala attended by Gordon Gekko, the film's main character.

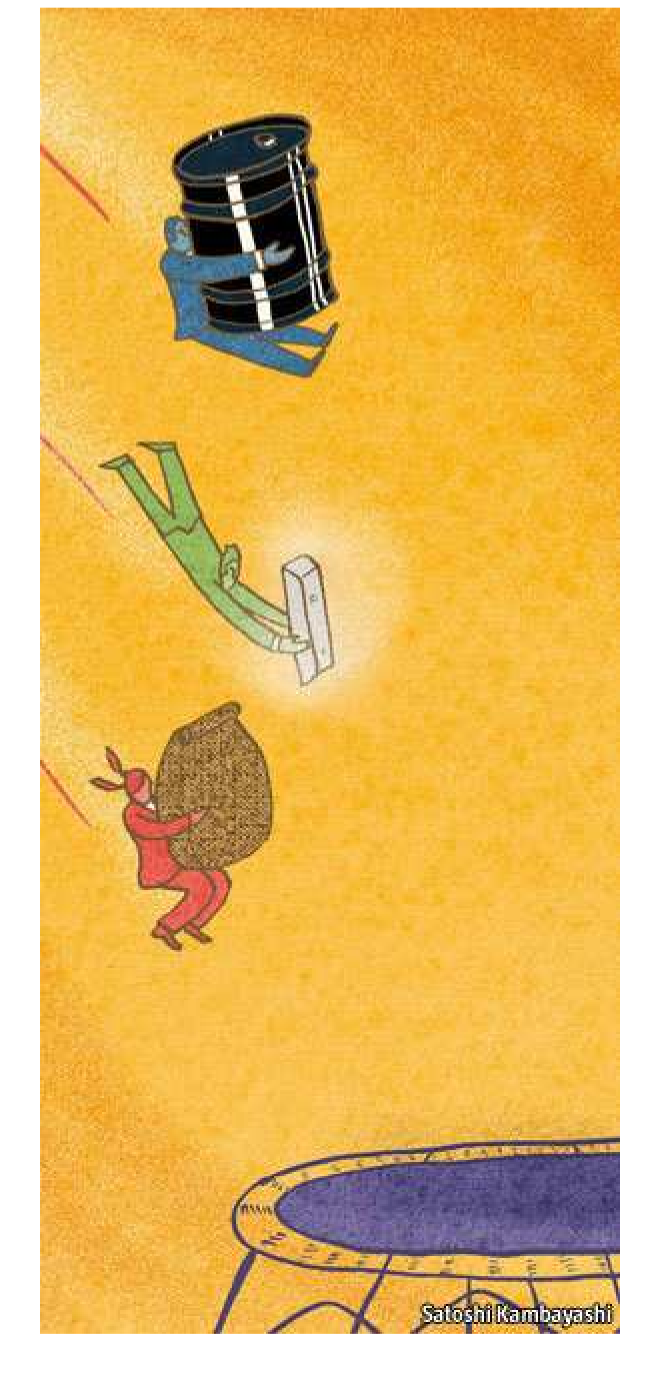
In his book, "Goodbye Gordon Gekko", a biography-cum-self-help guide published last year, he talks about his humble upbringing by Italian-American parents on Long Island, lambasts the culture of greed and ego on Wall Street and reflects on his success. "I am a capital artist," he writes without apparent irony. "My canvas just happens to be Wall Street and my brushes are the money managers for whom SkyBridge raises capital." Not everyone appreciates Mr Scaramucci's sense of perspective. But lots still show up in Vegas.

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Commodities markets (1)

A rocky patch

Despite a setback the raw-materials boom is not over yet



FOR many pundits there could be no clearer signal that commodities prices are at a peak than Glencore's preparations to go public later this month. The Swiss firm's canny traders are rarely on the wrong side of a deal and must surely intend to cash out at the top of the market. If so, was their timing a little off? In the same week that Glencore published its prospectus the price of many raw materials lurched downwards.

Leading the slump was silver, which fell by 30% in the first week of this month. On May 5th, the day which saw the worst of the carnage, oil plunged by nearly $10 a barrel. Most industrial metals suffered too, though the damage was not as bad: around 5% was knocked off both copper and zinc in a couple of days. Prices have been gyrating ever since.

There is a stockpile of explanations to draw on for the fall. Most suspicion fell on global macroeconomic prospects. The looming end of the Federal Reserve's quantitative-easing programme and weak economic data fuelled jitters about the American economy. In Asia, India's central bank and others raised interest rates to combat inflation, which added to disquiet about falling demand. But these jabs did not seem to add up to the knockout punch that commodities had taken.

Speculators also came under scrutiny. Most of the trouble began after the Chicago Mercantile Exchange, suspecting a bubble, had raised margin requirements for silver-futures traders three times in a week. "Poor man's gold", which was trading at close to $50 an ounce, double its price six months ago, rapidly fell to just over $30. But the market for the precious metal is tiny and illiquid. How could its travails affect oil, the biggest and most liquid of commodity markets?

The explanation for the fall in commodity prices may not be as mysterious as many seem to think. As Colin Fenton of J.P. Morgan says, "it all started in the physical market." Japan's earthquake in March has had a profound effect on global industrial production, the most important determinant of commodity prices. J.P. Morgan thinks that production will grow

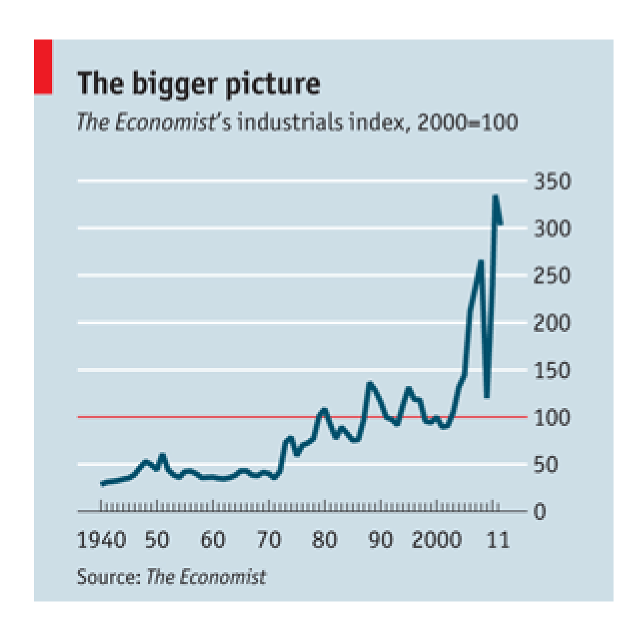
by 3.1% in the second quarter, compared with 6.8% in the prior three months. A correction had in any case quietly begun. Many commodities have been falling in price or steady for some months. Sugar was 35% off its February high even before the latest rout.

Mr Fenton also cites China's April trade figures as a sign that the country, so vital to commodity markets, has temporarily stepped back from its previous pace of commodity imports. Chinese imports of copper were sharply down. China uses 40% of the world's copper and has responded to sky-high prices by running down inventories. For oil, too, China has been importing far above its trend rate for some time and has room to step back from international markets.

Analysts also point out that the speed of the correction might have been unusual but not the magnitude. Kevin Norrish of Barclays Capital says that commodities followed similar downward trajectories in 2010, as Europe's sovereign-debt crisis flared, and 2009, as fears of a double-dip recession surfaced. Yet those slides happened over days or weeks. Many attributed the pace of the recent decline to "technical trading" where sell orders were placed automatically as markets fell, magnifying price swings.

Most analysts are brushing off the mini-crash as a minor setback to the commodities bull market. Commodities are still the best-performing asset class this year, according to Deutsche Bank. And there are good reasons to suspect that prices will stay high for a while yet. Before commodity prices collapsed in 2008, in the wake of the financial crisis and a rich-world recession, many pundits talked of a commodities "supercycle", a long period of sustained high prices. The term has gone out of fashion but the forces that prompted its use have endured.

Chinese demand, a consequence of industrialisation and urbanisation on a scale never seen before, has caused a profound structural shift for commodity markets. The country came from insignificance to become the dominant importer of many raw materials after 2003. Advocates of the supercycle theory reckon that we are only halfway through the upswing. Plenty more young Chinese, eager for new opportunities, are set to make their way to vast cities yet to be built, on roads and railways that are still twinkles in the eyes of central planners. Measures of energy and metals intensity, the relationship between GDP per person and consumption of oil and industrial metals, show that China still lags far behind not only the West but also neighbours such as South Korea.



All of which helps explain the terrific run that commodities have been on (see chart). Consumption of oil grew by 2.7m barrels a day in 2010; demand for copper, corn and many other raw materials was at an all-time high. Boosting supplies of oil and metals to meet this structural upswell in demand is not easy.

Even if China's emergence has brought secular price rises, it has not ironed out the cyclicality of commodities. Demand and supply are closely matched at the moment as the spare production capacity caused by the recession is eaten away. That means even small events can have a large impact. The commodities boom still has some way to go. But that does not mean prices will rise smoothly.

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Buttonwood

Getting the story right

What does the rise (and fall) of commodity prices imply for investors and the economy?



BULL markets tend to develop their own narratives to explain, and maintain, their momentum. Such stories encourage new investors to take part and to keep existing investors in the game. The story might be that a novel technology, such as the internet, will change the world, or that a "wall of money" from some new investors, such as the Japanese in the 1980s, will carry prices higher.

Since March 2009 there has been a remarkable rally in both equity and commodity prices which has continued, with occasional interruptions, despite problems like Europe's debt crisis. Three competing narratives have developed in an attempt to explain this concatenation.

The conventional story is that rising commodity prices, as well as higher stockmarkets, are simply indicators of a normal recovery. A rally was only to be expected after central banks slashed interest rates and governments allowed their budget deficits to expand. Corporate profits have rebounded strongly and stockmarkets are fairly valued on the basis of prospective earnings forecasts. As for sovereign debt, the euro zone will muddle through and America still has plenty of time to deal with its deficit. After all, the Treasury-bond market is showing no signs of alarm.

The second narrative is that higher commodity prices are the result of lax monetary policy, particularly in America, which is "leaking out" into emerging markets and into speculative activity. The price of gold in particular is heralding a coming surge in inflation, as is the weakness of the dollar. Treasury-bond yields have not risen yet but that is because they have been suppressed by the effects of quantitative easing (QE) and buying by Asian central banks.

The third story is a deflationary one, and says that the economic recovery is something of a Potemkin village, kept intact only by dint of central-bank and fiscal stimulus. Once central banks stop QE and the effects of fiscal tightening kick in, the whole edifice will collapse. On this view higher commodity prices are merely accelerating the process by acting as a tax on Western consumers. The sharp fall in commodity prices earlier this month, which followed some weaker-than-expected economic data, was a sign that the end-game was under way.

The emerging markets play a different role in each of these narratives. For the first camp, the developing countries were vital in propping up the economy during the dark days of 2009. They will also be crucial in the future, providing much-needed demand as the global economy rebalances away from its dependence on American consumers. The other two schools of thought take a much less positive view, seeing the developing countries as playing a central part in forcing up commodity prices with adverse effects across much of the rich world.

None of the three narratives manages to encompass all the market and economic data. Take the conventional case. If this is a typical recovery, why are central banks still keeping interest rates at crisis levels? The inflationists need to explain how higher prices will be generated when there is spare capacity in the global economy and weak wage growth. And the deflationists struggle to explain the rebound in world trade and the buoyancy of manufacturing.

Does the sharp fall in commodity prices on May 5th make any of these stories more plausible than the others? The inflationary story has taken a definite hit. The doves at the Bank of England and the Federal Reserve will take heart, and the European Central Bank might be slower to tighten policy than some expect.

The notion of a conventional recovery is dented, but only a bit. Although the sell-off followed some disappointing economic data, equity markets quickly rebounded once decent American non-farm payroll numbers had given investors some reassurance. The commodity sell-off can be explained as the occasional shake-out of speculators that is an inevitable part of a bull run.

The deflationists will interpret the commodity-price downturn as a sign that the bubble is about to burst. Tim Lee of pi Economics, a consultancy, sees a commodity crash as heralding a similar collapse in stockmarkets. For this school to be right, more evidence will be needed in the second half of the year. The lagged effects of European fiscal austerity and Chinese monetary tightening should be having an impact by then, and the Federal Reserve's QE programme will end in June. If the recovery has indeed been a sham, it should become clear soon.

Economist.com/blogs/buttonwood

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Commodities (2)

The price is wrong

The world's commodities flow through Asia, but prices are set elsewhere



Golden opportunity

IN OTHER places the talk may be of consolidation but in Hong Kong the number of exchanges is rising. On May 18th the brand-new Hong Kong Mercantile Exchange will begin trading a dollar-denominated futures contract tied to the physical delivery of gold. It hopes to follow with contracts for petroleum, grains and every other commodity that can be imagined.

Does the world really need another commodities exchange? Perhaps not, but China does. The world's largest consumer of commodities has already created futures exchanges in Dalian, Zhengzhou and Shanghai that have collectively become the largest in the world. But for all their successes these markets have failed in one critical respect: huge volumes have not led to their playing a central role in price discovery. Traders say futures are still priced off smaller markets in London and Chicago, even though prices there are often tied to factors that have nothing to do with Asia. That plays havoc with hedging strategies.

There are three reasons for China's failure to exert more control over price discovery. First, as is often so in its financial markets, foreigners are largely excluded, meaning a huge source of information on the supply side is absent. Second, there is no legal certainty that trades will be honoured, particularly if the loser is a politically connected company. An informed trader with a contrarian opinion may thus not gain from his insights. Third and more broadly, although Chinese businessmen may be among the world's most enthusiastic hagglers, the Chinese government is perpetually at war with the market, whether the issue is the level of its currency or what a private company charges for soap: witness the fine recently handed out to Unilever, a consumer-goods firm, for talking about price increases.

Creating a new exchange is never easy. The lack of initial volume is an obstacle to anyone searching for a price. But the newcomer has powerful backers, including China's biggest bank (ICBC) and shipping company (Cosco) as well as a Russian energy and commodity behemoth (EN+ group). And Asian companies are keen to be able to buy standardised, legally enforceable and transparent securities whose prices are linked to the local supply of and demand for metals, petrol and grains. The contradictions within China's system impede the creation of a proper market. Hong Kong may do better.

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Money-market funds

The long road back to boring

The industry dodges radical reform

BRUCE BENT, a money-market-fund pioneer, liked to say that his industry was doing its job only if it bored you to sleep, because it was expected to invest in safe, short-term securities. After the fall of Lehman Brothers, however, it became terrifyingly exciting. When one of Mr Bent's own funds "broke the buck", falling below the $1 net asset value (NAV) that is sacrosanct to the individuals, companies and local governments that park their cash in such places, a run on the industry ensued. The government was forced to issue a blanket guarantee that expired in September 2009.

Money-market funds are a vital source of short-term funding for companies, banks and governments. They hold $2.7 trillion in assets and buy more than a third of all commercial paper. As a market, if not individually, they are too big to fail. Regulators have devoted much attention to making banks more resilient, but they have been less sure-footed when it comes to fixing a system that Sheila Bair, the departing head of the Federal Deposit Insurance Corporation (FDIC), calls "broken".

Some argue that policy action can wait because the industry has reduced risk-taking. "Prime" funds, which invest in both corporate and government debt, have shifted into Treasury securities and certificates of deposit at the expense of corporate debt, which now comprises 30% of assets, half the level in 2006.



But they remain exposed to potential nasties, not least European bank debt (see chart). Europe's banks need money funds to finance their hefty dollar assets; the funds, meanwhile, have had fewer alternative places to invest since the disappearance of big debt issuers such as Lehman and the waning of asset-backed commercial paper. To be fair, money funds have cut their exposure to banks in the most troubled European countries. But some would be hurt in a euro-quake. And were they to pull back, banks would feel the loss of funding very quickly.

Regulators initially focused on floating funds' NAVs, since fixing them at $1 fosters expectations of safety that cannot always be met-or, as one regulator puts it, "allows investments to pose as bank accounts". But they have grown more sympathetic to industry concerns that investors would shun floating-NAV funds, leaving borrowers in the lurch. Treasurers of American firms mostly support keeping fixed NAVs.

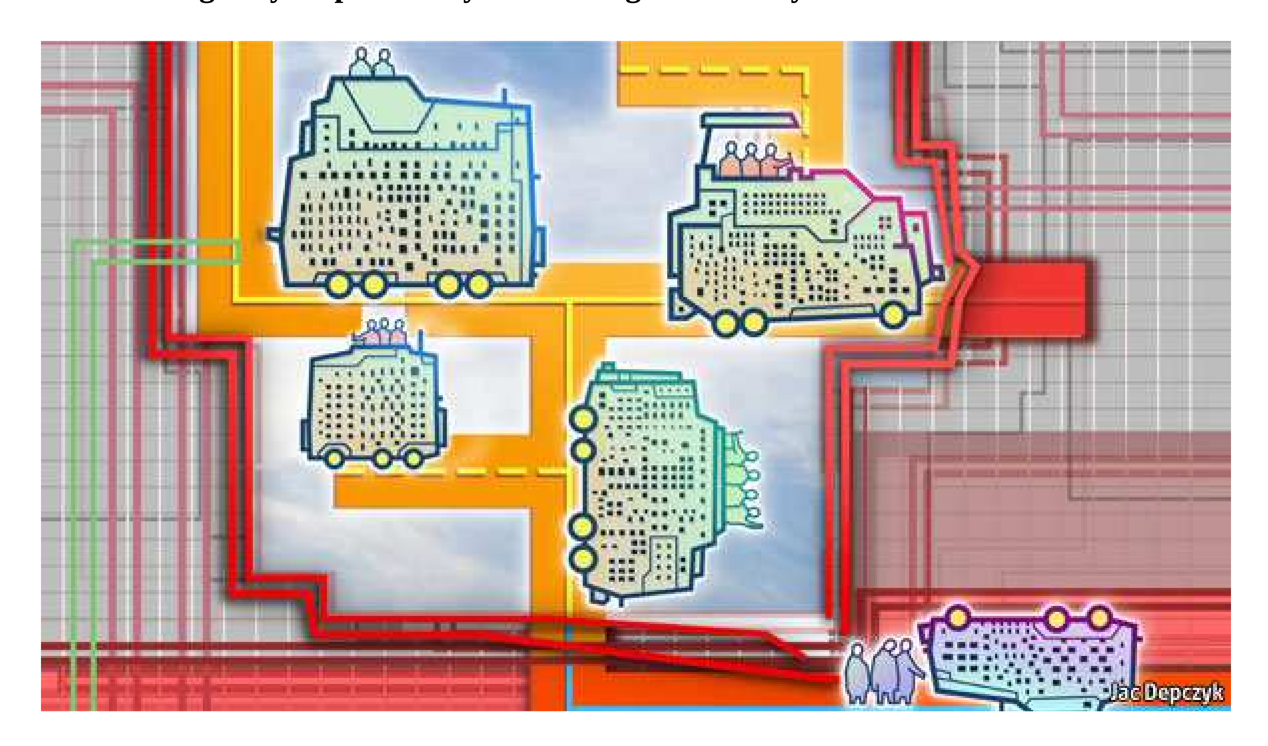
The proposal that seems to be gaining most traction is for a liquidity facility funded by a levy on the industry, akin to the FDIC's deposit-insurance scheme for banks. The fund could be structured as a bank, with access to emergency funding from the Federal Reserve. It would not bail out tottering funds but would buy securities from their healthy peers in a panic, helping them to meet redemptions.

Some large fund-sponsors are pushing other ideas. Fidelity suggests that each fund build its own buffer by putting aside retained earnings (ie, shareholder funds). JPMorgan Chase is pushing capital reserves provided by the funds' sponsor or its parent. These options give money funds more of a bank-like cushion, but none is perfect. Policing funds' capital buffers would be tricky. Any liquidity facility may be too small to shore up the entire industry in a 2008-like storm. Central bankers are queasy about extending emergency-loan access to a new sector. But such ideas are all better than nodding off.

Economics focus

Ties that sometimes bind

Fiscal rules to ensure budgetary responsibility are often ignored. They can still be useful



BUDGETARY discipline comes hard to governments. A new tax cut or spending increase may mean the difference between electoral success and failure. The task of deficit reduction will fall somewhere in the distant future. Once big debt burdens appear they are frustratingly hard to dispatch. The buck is passed between politicians but seldom paid off.

The solution for many governments is to impose fiscal rules that limit their own and their successors' freedom of movement. By setting borrowing limits or promising to punish reckless budgeting, politicians hope to force themselves to act more responsibly. Some 80 countries now have fiscal rules in place, according to the IMF, up from just seven in 1990. Faced with a severe debt crisis, euro-zone leaders are planning to strengthen existing constraints. America's divided government, unable to reach a comprehensive deal to bring budgets back to balance, may soon adopt targets that, if breached, trigger spending cuts or tax rises.

Fiscal straitjackets come in many shapes and sizes. Balanced-budget rules are the most common. Germany's newish constitutional "debt brake" will require the country's structural budget deficits to stay below 0.35% of GDP from 2016. America's pay-as-you-go rule in the 1990s was a variation on this idea. Before it expired in 2002, the rule forced Congress to "pay for" tax and entitlement-spending changes with offsetting budget fixes, so that any new measure would be deficit-neutral over five and ten years. Limits on debt or spending levels can also be used.

The big problem is enforcement. Given the option to change the rules rather than take measures to comply with them, many governments will choose the former. Under the euro area's stability and growth pact (SGP), economies running deficits larger than 3% of GDP were supposed to trim their structural deficits by 0.5% of GDP per year or face fines. But Europe's institutional weaknesses deterred enforcement of this provision: sanctions on countries that breached deficit limits were waived. America's legal debt ceiling has been raised 74 times since 1962. A 75th increase will be necessary by early August to stave off default. America's Gramm-Rudman-Hollings law, passed in 1985 and discarded in 1990, was designed to initiate cuts in discretionary spending across the board when triggered. The threat of blunt and unpleasant action was supposed to encourage pre-emptive deficit reduction. Instead, Congress responded to soaring deficits by passing a more flexible rule.

Despite this chequered past, rules do have a positive effect. An IMF analysis in 2009 of 24 large fiscal adjustments since 1980 found that it helped to have formal budgetary constraints. Economies that already had rules in place slashed debt levels by nearly 30% of GDP on average. Countries that adopted new rules as part of their adjustment cut debt by 39% of GDP. Those with no rules at all managed a reduction of only 20% of GDP. Fiscal adjustments persisted for nearly two years longer in countries that had rules than in those without them. Cuts were more front-loaded: the drop in primary budget deficits (ie, excluding interest payments) in the first three years of a consolidation programme was seven times larger in countries with fiscal rules.

Even the Maastricht criteria for joining the European Union and the SGP have not been quite the failures they are often perceived to be. The carrot of EU membership seems to have worked on countries heading towards accession. Slovakia, for example, trimmed its structural budget deficit from 11.4% of GDP in 2000 to 2.3% in 2004, the year it joined the club. (By 2009, however, the gap had widened again, to 6.4% of GDP.) The SGP seems to have curtailed the use of discretionary fiscal policy in the euro area, reducing overall economic volatility. The euro zone's ratio of gross debt to GDP declined slowly but steadily before the crisis, from 73.7% in 1996 to 68.5% in 2006.

The rules did not prevent the debt crisis in Europe, of course, but the banking bust and the downturn were partly to blame for that. In recessions tax revenues fall and spending needs rise. Before the crisis Spain's structural budget deficit was well within allowable limits and its debt levels were falling. But a calamitous recession and higher unemployment undid this work.

Some of Europe's fiscal improvements were illusory, however. Ireland and Spain relied on windfall property revenues. Sales of non-financial public assets often spike before countries join the single currency, as governments temporarily bring down borrowing without actually improving fiscal balances. Studies also show a surprisingly large divergence between the level of euro-area debts and the sum of countries' accumulated budget deficits. These should be roughly equal but debt is often much larger, suggesting that some governments meet deficit targets by moving borrowing off their balance-sheets.

Rules about rules

The nature of the cuts that governments make to meet their targets also matters. If the composition of spending is not considered, governments may give short shrift to projects with long-term benefits, like capital investments, while sparing powerful interest groups. Fiscal rules may also hurt the poor as officials slash benefits in order to protect pet government projects and public-sector pay. Both problems have been seen in Europe since the introduction of the Maastricht criteria.

A fiscal rule is only as good as its design. Targets should make allowances for big economic shocks: strict budget rules that require measures to prune deficits in a downturn risk further weakening the economy. They should be backed by institutions such as independent fiscal councils. The more direct and credible the enforcement mechanism, the better. Even if these conditions are hard to meet in practice, fiscal constraints are often more useful than no rules at all. Whether trimming a debt burden or preserving a surplus, politicians often do best by tying their hands.

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Twins and motherhood

Thrice blessed

Mothers of twins do not just get twice the bundle of joy-they are also healthier than other mothers



THROUGHOUT history, twins have provoked mixed feelings. Sometimes they were seen as a curse-an unwanted burden on a family's resources. Sometimes they were viewed as a blessing, or even as a sign of their father's superior virility. But if Shannen Robson and Ken Smith, of the University of Utah, are right, twins have more to do with their mother's sturdy constitution than their father's sexual power.

At first blush, this sounds an odd idea. After all, bearing and raising twins is taxing, both for the mother and for the children. Any gains from having more than one offspring at a time might be expected to be outweighed by costs like higher infant and maternal mortality rates. On this view, twins are probably an accidental by-product of a natural insurance policy against the risk of losing an embryo early in gestation. That would explain why many more twins are conceived than born, and why those born are so rare (though more common these days, with the rise of IVF). They account for between six and 40 live births per 1,000, depending on where the mother lives.

Dr Robson and Dr Smith, however, think that this account has got things the wrong way round. Although all women face a trade-off between the resources their bodies allocate to reproduction and those reserved for the maintenance of health, robust women can afford more of both than frail ones. And what surer way to signal robustness than by bearing more than one child at a time? In other words, the two researchers conjectured, the mothers of twins will not only display greater overall reproductive success, they will also be healthier than those who give birth only to singletons.

Alas, pinning down evolved relationships between fertility and health is tricky. Modern medicine and the pampering effects of economic growth mean that, these days, women everywhere give birth to fewer children than they did in the distant evolutionary past, when human bodies and physiology were forged-even as more of the offspring they do bear survive into adulthood. In Europe and North America this demographic transition began in earnest around 1870.

Twinned with Salt Lake City

One way round this is to look at records gathered before the demographic transition began. The problem is that few authorities then kept tabs diligently enough to provide adequate fodder for statistical analysis. One exception was Utah, a state largely settled in its early days by Mormons, who have always taken such matters seriously. As a result, Utah's Pedigree and Population Resource, a database of which Dr Smith is the director, contains 1.6m genealogical records for people in the state from the early 1800s to the 1970s.

To test their theory that the bearers of twins are supermums, Dr Robson and Dr Smith scoured the records for women born between 1807 and 1899 who survived past the age of 50, when the menopause typically strikes. They excluded those married more than once, those widowed before they were 50 and also (this being Utah) those wives who were part of one of the polygamous marriages once legal among the state's Mormon settlers. (In a study published earlier this year, Dr Smith and his colleagues found that the more wives a Mormon woman had to compete with for her husband's attentions, the fewer children she was likely to produce.) This left them with some 59,000 women, around 4,600 of whom had given birth to twins at least once.

To assess the effects of the demographic transition, the two researchers split the sample into women born before 1870 and those born in or after it. The results, just published in the *Proceedings of the Royal Society*, confirm their hypothesis. Mothers of twins in the pre-1870 batch gave birth, on average, to 1.9 more children than the mothers of singletons. Those in the post-1870 batch had 2.3 more. More importantly, from an evolutionary point of view, more of their children made it to maturity. The mothers of twins in the pre-1870 batch had 1.24 more children who survived past the age of 18 than did other mothers. After that date the figure was 1.56.

Of course, having twins automatically increases a mother's lifetime fertility by one, relative to her number of pregnancies. But, since few women have twins more than once, the data imply that mothers of twins are more productive, even ignoring that effect. Moreover, they also outperformed the mothers of singletons on a range of other reproductive measures, including intervals between births (shorter) and the age at which they gave birth to their last child (older).

Most strikingly, the pre-1870 group of mothers of twins actually lived longer than those who were not thus blessed. They were, in other words, simply healthier. This suggests that, in evolutionary terms at least, twins are far from a curse. On the contrary, they are indeed the mark of a supermum.

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Teaching methods

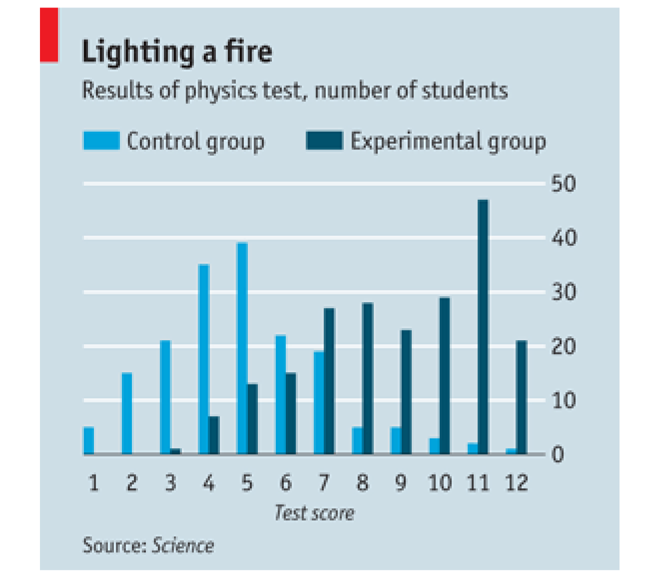
An alternative vote

Applying science to the teaching of science

AS DOES much else in the universe, education moves in cycles. The 1960s and 1970s saw a swell of interest in teaching styles that were less authoritarian and hierarchical than the traditional watching of a teacher scribbling on a blackboard. Today, tastes have swung back, and it is fashionable to denigrate those alternatives as so much hippy nonsense.

But evidence trumps fashion-at least, it ought to. And a paper just published in *Science* by Louis Deslauriers and his colleagues at the University of British Columbia suggests that at least one of the newfangled styles is indeed superior to the traditional chalk-and-talk approach.

Dr Deslauriers's lab rats were a group of 850 undergraduate engineering students taking a compulsory physics course. The students were split into groups at the start of their course, and for the first 11 weeks all went to traditionally run lectures given by well-regarded and experienced teachers. In the 12th week, one of the groups was switched to a style of teaching known as deliberate practice, which inverts the traditional university model. Class time is spent on problem-solving, discussion and group work, while the absorption of facts and formulae is left for homework. Students were given reading assignments before classes. Once in the classroom they spent their time in small groups, discussing specific problems, with the teacher roaming between groups to offer advice and respond to questions.



At the end of the test week, Dr Deslauriers surveyed the students and gave them a voluntary test (sold as useful exam practice, and marked on a 12-point scale) to see how much they had learned in that week and what they thought of the new teaching method. The results were striking (see chart). The traditionally taught group's average score was 41%, compared with 74% for the experimental group-even though the experimental group did not manage to cover all the material it was supposed to, whereas the traditional group did.

According to Dr Deslauriers and his team, their result is the biggest performance boost ever documented in educational research, making the new teaching style more effective even than personal, one-to-one tuition-although measuring the effect immediately after the experiment, rather than waiting for end-of-term exam results (as other research often has), may have inflated the number somewhat. The results are especially impressive given that the deliberate-practice method was applied by teachers with little prior experience of using it, whereas the traditionally taught students had the benefit of a seasoned lecturer with a long record of good ratings from pupils.

One frequent criticism of these sorts of studies concerns something called the Hawthorne effect, an idea which emerged from post-war work on productivity. This is that change of any sort will boost people's performance simply because of the novelty value it offers. But the exact nature of the Hawthorne effect, and even whether it exists at all, is controversial. Moreover, if it is real, it would be unlikely to apply in this case, because it is supposed to occur mainly among people doing routine jobs, for whom any change in working practices is welcome. That is not a description of a typical undergraduate's life.

A more serious objection is that the study's participants may be an atypical group. The sort of people who study engineering may react better (or, indeed, worse) to the deliberate-practice method than, say, those reading fine art or history.

Still, Dr Deslauriers and his team are bullish about the wider implications of their work, which adds to the evidence that it may be possible to improve on the long-established chalk-and-talk method. And the students seemed to enjoy the experience, too. Attendance in the experimental group rose by 20% over the course of the week that deliberate practice was used, and three-quarters of its members said that they would have learned more had the entire course been taught in the same way. In this case, then, the educational hippies may have been right.

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Solar power

The third way

A new method of making electricity from sunlight has just been tested

AT THE moment, there are two reliable ways to make electricity from sunlight. You can use a panel of solar cells to create the current directly, by liberating electrons from a semiconducting material such as silicon. Or you can concentrate the sun's rays using mirrors, boil water with them, and employ the steam to drive a generator.

Both work. But both are expensive. Gang Chen of the Massachusetts Institute of Technology and Zhifeng Ren of Boston College therefore propose, in a paper in *Nature Materials*, an alternative. They suggest that a phenomenon called the thermoelectric effect might be used instead-and they have built a prototype to show that the idea is practical.

Thermoelectric devices are not new. They are used, for example, to capture waste heat from car engines. They work because certain materials, such as bismuth telluride, generate an electrical potential difference within themselves if one part is hotter than another. That can be used to drive a current through an external circuit.

The reason thermoelectric materials have not, in the past, been applied successfully to the question of solar power is that to get a worthwhile current you have to have a significant temperature difference. (200Âº C is considered a good starting point.) In a car engine, that is easy. For sunlight, however, it means concentrating the heat in some way. And if you are going to the trouble of building mirrors to do that, you might as well go down the steam-generation route, which is a much more efficient way of producing electricity. If the heat concentration could be done without all the paraphernalia of mirrors, though, thermoelectricity's inefficiency would be offset by the cheapness of the kit. And that is the direction in which Dr Chen and Dr Ren hope they are heading.

In their view, three things are needed to create a workable solar-thermoelectric device. The first is to make sure that most of the sunlight which falls on it is absorbed, rather than being reflected. The second is to choose a thermoelectric material which conducts heat badly (so that different parts remain at different temperatures) but electricity well. The third is to be certain that the temperature gradient which that badly conducting material creates is not frittered away by poor design.

The two researchers overcame these challenges through clever engineering. The first they dealt with by coating the top of the device with oxides of hafnium, molybdenum and titanium, in layers about 100 nanometres thick. These layers acted like the anti-reflective coatings on spectacle lenses and caused almost all the sunlight falling on the device to be absorbed.

The second desideratum, of low thermal and high electrical conductivity, was achieved by dividing the bismuth telluride into pellets a few nanometres across. That does not affect their electrical conductivity, but nanoscale particles like this are known to scatter and obstruct the passage of heat through imperfectly understood quantum-mechanical processes.

The third objective, efficient design, involved sandwiching the nanostructured bismuth telluride between two copper plates and then enclosing the upper plate (the one coated with the light-absorbing oxides) and the bismuth telluride in a vacuum. The copper plates conducted heat rapidly to and from the bismuth telluride, thus maintaining the temperature difference. The vacuum stopped the apparatus losing heat by convection.

The upshot was a device that converts 4.6% of incident sunlight into electricity. That is not great compared with the 20% and more achieved by a silicon-based solar cell, the 40% managed by a solar-thermal turbine, or even the 18-20% of one of the new generation of cheap and cheerful thin-film solar cells. But it is enough, Dr Chen reckons, for the process to be worth considering for mass production.

He sees it, in particular, as something that could be built into the solar water-heaters that adorn the roofs of an increasing number of houses. If such heaters were covered with thermoelectric generators the sun's rays could be put to sequential use. First, electric power would be extracted from them. Then, the exhaust heat from the bottom plate of the thermoelectric device would be used in the traditional way to warm water up. Two-for-one has always been an attractive proposition for the consumer. This kind of combined heat and power might enable more people to declare independence from the grid.

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The sixth sense of seals

Oh my ears and whiskers!

Pinnipeds are able to distinguish an object's shape by its wake



LIKE their land-lubbing kin the cats, seals are equipped with sensitive facial whiskers. Incredibly sensitive, as it turns out. The sophistication of this sixth seal sense has just been shown by Wolf Hanke and Sven Wieskotten of the University of Rostock, in Germany, working in collaboration with Henry, a 12-year-old harbour seal who has a long history of assisting in such experiments. Henry showed himself able to distinguish the shapes of passing objects from their wakes, even when those objects were no longer in the water.

In an experiment that might quicken the heart of an interrogator at Guantanamo Bay, Henry was blindfolded with a rubber mask made from a latex stocking, fitted with a set of headphones that played pink noise (not a progressive rock band from the 1970s, but a type of random sound in which each octave has an equal amount of power) and made to stick his head in a water-filled box. Unlike a suspected terrorist, though, he did so voluntarily-in exchange for rewards in the form of pieces of herring.

After a rigorous training regime that lasted 26 weeks, Henry was deemed ready for action. The box had an opening big enough for the seal to put his head in, but not large enough for him to enter completely. Inside it, an electric motor swept a paddle around before each experimental run and then, three seconds after the paddle had finished its sweep, Henry was given the signal to go to the box and place his head in it.

On the first run, the tank was stirred with a reference paddle (initially, a standard, flat shape with a width of two, six or eight centimetres). Having experienced this reference, Henry's task was to decide whether subsequent stirrings used the reference paddle or a different one. He indicated his choice by pressing one of two targets within the box, using his nose. Correct decisions were rewarded with herring.

At first, the experimental and reference paddles differed only in size, not shape. In this case Henry proved able to distinguish the wakes of paddles whose widths varied by 2.8cm or more. That, however, was merely the beginning. Dr Hanke and Mr Wieskotten then tested Henry with the wakes of paddles of different shapes: triangular, cylindrical, flat and undulating. Henry successfully distinguished between the flat and cylindrical paddles, the flat and undulating paddles and the undulating and cylindrical paddles. He was, though, unable to separate the triangular paddle from the undulating and cylindrical ones.

The point of this study, just published in the *Journal of Experimental Biology*, is to understand better how seals hunt fish in the inky depths of the ocean. Those other mammalian marine predators, the dolphins, use sound to "see" in places where little light penetrates. The reflections of the clicks they generate tell them whether anything nearby might make a tasty meal. Seals do not click in this way, but they do have remarkable whiskers. With this experiment Dr Hanke and Mr Wieskotten have shown that a hangover from the animals' terrestrial ancestors has been adapted to produce a sense as

sophisticated as a dolphin's sonar and one which, presumably, allows them to work out from its wake whether a particular fish is actually worth pursuing.

The lessons of philanthropy

Giving for results

There is more to philanthropy-much more-than just giving money away

Leap of Reason: Managing to Outcomes in an Era of Scarcity. By Mario Morino. *Venture Philanthropy Partners; 149 pages; $10.* leapofreason.org

Give Smart: Philanthrophy That Gets Results. By Thomas Tierney and Joel Fleishman. *PublicAffairs; 257 pages; $23.99 and pound12.99.* Buy from Amazon.com, Amazon.co.uk

Do More Than Give: The Six Practices of Donors Who Change the World. By Leslie Crutchfield, John Kania and Mark Kramer. *Jossey-Bass; 250 pages; $29.95 and pound19.99.* Buy from Amazon.com, Amazon.co.uk



WHETHER America's famed philanthropic tradition is all it is cracked up to be will become much clearer during the next few years. Superficially, that tradition has emerged from the global financial crisis in remarkably good shape. In the past year some 69 of America's billionaires and billionaire families have promised to give away at least half of their fortunes by signing the Giving Pledge championed by Bill Gates and Warren Buffett, two of the world's richest men. Among them is 27-year-old Mark Zuckerberg, a founder of Facebook, proof that America's giving gene has passed to the next generation.

The question is, will all that giving, by the billionaires and the thousands more Americans with far smaller amounts of money, actually do any good? There is rather a depressing history of well-intentioned donations often doing nothing to alleviate society's problems, and sometimes even making matters worse. As Mr Buffett has said many times, "making money is far easier than giving it away effectively." Moreover, the need to give effectively, to maximise the bang for every charitable buck, is about to become even greater, as many of the organisations that receive their funds from private philanthropy or the public sector begin to feel the effects of America's fiscal problems. Spending cuts will cause a crisis in the social sector that "will have an impact on almost every non-profit [organisation] in America, whether or not it receives

government funds," writes Mario Morino, a veteran philanthropist, in "Leap of Reason", one of three new books that address the same thorny question of how to not merely give, but to give well.

As evinced by his subtitle, "Managing to Outcomes in an Era of Scarcity", Mr Morino focuses on delivering results, as do the other authors, with their emphasis on smart giving and changing the world. The books draw examples from the many years the authors have spent promoting better philanthropy, and are all worth reading. Only Mr Morino is actually in the process of giving away a fortune he earned for himself, which makes him less prone to wrapping his iron fist in a velvet glove than the other authors, who are all professional philanthrocrats of different kinds. Joel Fleishman raised a fortune for Duke University and ran the American arm of the Atlantic Philanthropies; Thomas Tierney gave up his role as boss of Bain to found Bridgespan, a consulting firm for non-profits; the three authors of "Do More Than Give" work for FSG, another consultancy.

For Mr Buffett, the main reason why giving is harder to do than making money is that in business "you go after the low-hanging fruit", whereas in philanthropy you are trying to tackle problems that are inherently difficult, such as how to educate demotivated urban kids or end rural poverty. But all three books make the case that the ineffectiveness of much philanthropy is actually the fault of the philanthropist. They applaud the motives for giving, but all make the point that people too often let their philanthropy be guided by their hearts alone. "Deciding what you will do to make change happen is a choice that requires both your head and your heart", write Messrs Fleishman and Tierney in the best chapter in "Give Smart", entitled "What Am I Accountable For?" The biggest problem for philanthropists, they argue, may be that "they are essentially accountable to no one but themselves." To avoid being tempted into a self-deluded belief in their own success, philanthropists should create systems that force them to hear what may at times be unpleasant truths about the ineffectiveness of their work, and to be constantly challenged to improve.

Of the six practices of effective philanthropists described in "Do More Than Give", two stand out as being unusual. To achieve real change-what the authors, Leslie Crutchfield, John Kania and Mark Kramer, call "catalytic philanthropy"-the best course may be to engage in political advocacy to change government policy, they argue. The Bill & Melinda Gates Foundation is doing this a lot more than most, on issues ranging from education reform to international aid. But the advice also works at a local level, as the book illustrates through the story of how the Tow Foundation improved juvenile justice policy in Connecticut. Their second sound piece of advice is that philanthropists should work together more often. This seems obvious, but as the authors rightly ask, "Why don't more foundations actively collaborate with their peers?"

For Mr Morino, a pioneer of "venture philanthropy", in which the donor works closely to build up the non-profits he supports, one of the key lessons is for philanthropists and non-profits to be clear about the outcomes they are trying to achieve- and to measure properly the progress they are making towards those goals. He is the first to admit that measuring the right thing is not easy, and he has wasted money by measuring the wrong things. Yet far too many philanthropists and non-profits shy away from setting goals and measuring progress. As a result they condemn themselves to ineffectiveness. This must change if philanthropy and the non-profit sector it helps to fund is to achieve the "quantum leap" in effectiveness that he believes is an urgent priority. As he says, "the time to dramatically improve our collective impact is now, when we are needed most."

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World economic growth

When the poor catch up

The challenges of growing richer

The Next Convergence: The Future of Economic Growth in a Multispeed World. By Michael Spence. *Farrar, Straus and Giroux; 320 pages; $27.* Buy from Amazon.com

MICHAEL SPENCE has long been pointing out the frictions that interfere with efficient markets. He won the Nobel prize in economics for this in 2001, together with George Akerlof and Joseph Stiglitz. In recent years Mr Spence has been preoccupied with the economics of development and growth, and his interest in laissez-faire's flaws has stayed with him.

His new book, "The Next Convergence", warns of the frictions that arise when the world tries to accommodate both rapidly-growing emerging giants like India and China and slow-growing developed countries like America.

Never before have so many people grown rich so quickly. Japan was the first country to achieve sustained, high-speed growth, in the post-war years, but it did so alone. A handful of smallish Asian tigers followed. Mr Spence wonders whether that formula can work when 60% of humanity, led by India and China, try the same thing. Globalisation, he notes, has been critical to the rapid growth of emerging markets. But it has also led to rising inequality in the rich countries, and they may now well respond by raising protectionist barriers. Or maybe not. Mr Spence is not sure about this nor, unfortunately, of many of the other issues he tackles. "The Next Convergence" feels less like a book than a transcript of the author thinking out loud about a hotch-potch of contemporary economic issues.

Mr Spence surveys the state of knowledge of growth and development economics, touching on the role of foreign aid, trade liberalisation, natural resources and the difficulty that countries experience when they begin evolving from middle-income nations to more advanced economies. He breaks little new ground and sticks to broad generalities, offering little in the way of examples or research to prove his point. The text is also thick with such phrases as "suboptimal noncooperative outcomes" and "systematically impactful". Readers new to the field may find this book a useful overview, but only if they can endure the ponderous writing.

This is a pity because Mr Spence has much to offer from a rich career in research, academia and global policymaking. The reader occasionally glimpses his experiences, in particular in his analysis of China. He describes how Deng Xiaoping, China's paramount leader until the early 1990s, realised that the country could accelerate its development by learning from Western experts, such as the World Bank, how markets work rather than feeling its way by trial and error. He also illustrates how China's leaders are grappling with reorienting growth from labour-intensive manufactured exports to capital-intensive services aimed at domestic consumers.

Mr Spence is no fire-breathing ideologue, but he clearly believes the world trusts too much in laissez-faire and not enough in government. America, he says, needs to spend more on unemployment insurance, industrial policy and public infrastructure. The world economy needs "enhanced coordinated oversight" and "global effective government". But he is never clear about what this would entail nor what good it would do. Mr Spence wants to replace the current hybrid of floating and fixed exchange rates-with "a new hybrid". That's as specific as he gets. He downplays the benefits of China letting its undervalued exchange rate rise while arguing later that it must do so anyway.

In short, Mr Spence has more questions than answers. That in itself is no bad thing. You need humility when evaluating the impact of globalisation, he says. But that makes for an unsatisfying book.

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The study of well-being

Strength in a smile

A new discipline moves to centre-stage

Flourish: A Visionary New Understanding of Happiness and Well-Being. By Martin Seligman. *Free Press; 368 pages; $26. Nicholas Brealey Publishing; pound14.99.* Buy from Amazon.com, Amazon.co.uk

The idea that it is the business of governments to cheer up their citizens has moved in recent years to centre-stage. Academics interested in measures of GDH (gross domestic happiness) were once forced to turn to the esoteric example of Bhutan. Now Britain's Conservative-led government is compiling a national happiness index, and Nicolas Sarkozy, France's president, wants to replace the traditional GDP count with a measure that takes in subjective happiness levels and environmental sustainability.



Here's how to beat anxiety

Martin Seligman, a former president of the American Psychological Association, would approve. He has uncovered various structured ways of perking people up, all of them, he insists on the very first page of his new book, "grounded in careful science". Much of this book consists of the results of various complex tests and interventions designed to reduce depression and anxiety and increase resilience and self-discipline. Writing a "what-went-well-today-and-why" diary for a week, for example, tends to lower depression levels for as much as six months, he claims.

"Flourish" represents a partial rejection of Mr Seligman's previous work, "Authentic Happiness" (a title he says was forced on him by his publisher). To focus solely on happiness rather than the more expansive concept of "well-being", Mr Seligman now says, is a form of "monism" that neglects important ingredients, such as "relationships" and "accomplishment".

Consider the decision to have children. Research consistently shows that parents are less satisfied with their lives than the childless. Yet the human race continues to propagate itself. Either, says Mr Seligman, we are "massively deluded" about the effects of children on our happiness, or we take more than "life satisfaction" into account when choosing to breed.

Mr Seligman's book is, in effect, an attempt to add dashes of both Aristotelian wisdom and Nietzschean grit to the stock of Benthamite utilitarianism that underlies much of the newer work in this field. Mr Seligman says he now rejects the Aristotelian view that all human action aims at happiness. But Aristotle's term, *eudaimonia*, usually rendered in English as "happiness," actually translates better as "flourishing". Moreover, Mr Seligman's emphasis on "good character" is reminiscent of the Aristotelian virtues (and chimes with recent work carried out in British think-tanks). As for Nietzsche, whose ironic writings seem to occupy another universe from Mr Seligman's empirically grounded "positive psychology", his idea that the "will to power" drives much human action finds ready approval here.

Mr Seligman has fans. Schools and universities around the world are using his work to craft happier, more robust students. A test designed by Mr Seligman and his colleagues to assess the psychological fitness of serving troops will, he says, be taken by all American soldiers every year. The many critics of positive psychology are unlikely to be swayed by this book, particularly given its tone, by turns cheesy and hubristic, and its sloppy editing. But they appear to be losing the argument.

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New poetry

Life in the shadow

Audacity and elegy

Six Children. By Mark Ford. *Faber and Faber; 61 pages; pound9.99.* Buy from Amazon.co.uk

The City with Horns. By Tamar Yoseloff. *Salt Publishing; 80 pages; pound9.99.* Buy from Amazon.co.uk

WALT WHITMAN casts a long shadow over modern poetry. His work, delighting in slang, cityscapes and the exuberance of being in the middle of a crowd, created a peculiarly American form of epic verse, with long lines stretching-seemingly endlessly-across the page. But, just as the iconic image of him in a wide-brimmed hat and open shirt can appear ridiculously romantic now, so too has his work been successively embraced and ignored by modern writers.

And so when a British poet and academic, Mark Ford, takes Whitman's claim that "though unmarried I have had six children" as the starting point for this third collection of poetry, he demonstrates a literary awareness that may not immediately appeal to every reader. Indeed, in "Six Children" Mr Ford, a lecturer at University College London, seems intensely preoccupied not only with the grandfather of American verse, but also with the Mau Mau insurrection and the Munster Anabaptists. Such a wide scope is impressive, and Mr Ford's enthusiasm for more obscure factual details, such as the decline of the passenger pigeon, shines through. However, when a succession of his poems turn out to be adaptations or loose translations of Petronius, Sappho, Pliny the Elder and Boethius, you may find yourself hankering after an original voice-even one as extravagant as Whitman's.

There are certain exceptions to this rule. Born in Kenya in 1962, Mr Ford writes deftly about moving to the London suburb of Surbiton, where the only reminder of his past home was "Red, African dust spilled from the wheels of our toy trucks and cars." His elegy for a fellow poet, Mick Imlah, shows a directness and clarity that is not always felt in his allusive poetry. These momentary glimpses into Mr Ford's life are tantalising, edging towards a striking poetic style. And yet when Mr Ford describes how "we hate/to be touched, however/gently, in a slow-moving crowd" we may not think only of the urban claustrophobia he speaks of but also of the experience of reading his poetry, peopled as it is with other poets, only some of whom it is pleasing to come into contact with.

It is a sensation that Tamar Yoseloff, American-born and now living in London, also writes of in her fifth collection, "The City with Horns". Ms Yoseloff describes how in a London bus "we are too intimate in this folded space", the edge-to-edge contact with a stranger's body momentarily disquieting. Like Mr Ford, Ms Yoseloff prefers the company of ghosts, taking the life of Jackson Pollock as the core of her book.

Over the course of 13 poems, Ms Yoseloff traces Pollock's explosive marriage to Lee Krasner, his death in a car crash aged 44, and the life of his mistress, Ruth Kligman, who survived the crash to be nicknamed "Death car girl". Ms Yoseloff skilfully gives voice to such figures through subtle shifts of tone, revelling in a particular kind of American slang.

Using such a well-known life is an audacious move, and Ms Yoseloff rises to the challenge. But the rest of the poems in her collection fail to live up to this drama, too often relying, like Mr Ford, on literary precedent. Both these collections have moments of joy, but their flaws make you want to turn to the writers that overshadow them.

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Thrillers in North Korea

Pyongyang confidential

The draw of a mysterious nation



Pyongyang: A Journey in North Korea. By Guy Delisle. *Drawn and Quarterly; 192 pages; $14.95*. Jonathan Cape; pound12.99. Buy from Amazon.com, Amazon.co.uk

Maximum Target. By Martin Gower. N*oirEast Publishing; 362 pages; pound9.* Buy from Amazon.co.uk

The Man with the Baltic Stare. By James Church. *Minotaur; 288 pages; $24.99 and pound17.99.* Buy from Amazon.com, Amazon.co.uk

ISOLATED and isolating, North Korea has made concealment a way of being. Which may be one reason why, as a setting, it lends itself so well to the imagination of thriller writers.

A clutch of recent potboilers use the setting, but reveal little. Perhaps the most unusual of these is Guy Delisle's "Pyongyang: A Journey in North Korea" (2006), the first and so far the only "graphic novel" to tackle life in the DPRK. Inspired by the author's experience as the liaison between a French animation studio and its Korean partner, it uses drab black-and-white drawings to depict the singular emptiness and mystery of the world's only neon-free capital city.

Hovering over this crepuscular world is the ever-present image of the Dear Leader, Kim Jong Il, the diminutive, shambling, designer sunglasses-wearing despot who-according to official sources- combines national leadership with the roles of philosopher, writer, opera composer, film director and world-class golfer. The day begins and ends with Mr Kim, who is seldom seen but always present. Pyongyang is the kind of city where a day-long visit to the museum of gifts presented to Mr Kim seems like quite an interesting diversion. Nothing much happens in the novel. But then, nothing much happens in Pyongyang-at least if you are lucky.

Various characters are not so fortunate in Martin Gower's "Maximum Target", which dispenses entirely with such niceties as the slow accumulation of texture and detail, and hurls the reader straight into a world of Japanese yakuza gangsters, drug dealers, massage-parlour girls and a conspiracy that ends with an attempt on the life of the North Korean dictator.

Mr Gower's characters have a depth that befits his rapid-fire global plots and counterplots-which is to say, not much. But the text is informed and witty, the North Korean scenes sketched with what reads like first-hand knowledge, and there is an engaging take on cultural preoccupations from Karl Marx to Jean-Paul Sartre and Bob Dylan, played out against the unlikely skyline of Pyongyang with its empty boulevards and permanently unfinished multi-storey hotels.

The same locations, albeit from a different angle, also appear in a series of crime novels written by James Church, the pseudonym of a former CIA operative in East Asia. Here the central character is a Pyongyang police officer, the likeable Inspector O, who knows that in North Korea mysteries are never solved, just absorbed into larger mysteries.

The first in the series, "A Corpse In The Koryo", which came out in 2006, is the least assured, but in some ways the most original. Daily life, rather than a particular crime, is the mystery here. Much of the story involves the inspector trying, never entirely successfully, to join the dots between one inexplicable event and the next, and connect them all to the murder of a foreigner that may or may not have taken place in the Koryo Hotel.

Mr Church keeps his own counsel, so it is not known how he comes by his information, but the scenic details and atmospherics suggest more than a passing acquaintance with the realities of life in North Korea. In the next two novels, "Hidden Moon" and "Bamboo and Blood", a subtle, indirect satire on a state develops that is too bizarre for comedy. Finally, in last year's "The Man with the Baltic Stare", Inspector O is called out of retirement to investigate a murder in Macao. Eventually it becomes clear that the job is not to solve the crime, but to obscure it.

This is a police procedural North Korea- style-fully inverted. It's not what you do that lets you get by in North Korea, it's what you don't do. Or as Mr Gower puts it, it is something like jazz; the notes you don't play are the notes that count.

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Antwerp's new museum

Tall tales

Changing a skyline-and a map



A new window on the world

IN PHOTOGRAPHS, Antwerp's newest museum, with its helter-skelter stack of enormous cantilevered boxes, looks worryingly exhibitionistic. In person, its expanse of red Indian sandstone and wavy ribbons of glass is beautiful, and not crackpot at all.

The design has an exciting, practical purpose. A Rotterdam firm of architects, Neutelings Riedijk, has created a squared-off spiral. The ten stacked-up boxes, the escalators connecting them and the floor-to-ceiling walls of undulating glass are positioned so that each of the building's levels offers a different sweeping panorama of the city and its river.

Antwerp is low slung. MAS, which stands for Museum aan de Stroom-*Stroom* means "river" in Dutch; Antwerp's is the Schedlt-rises above church spires and huge cranes. Excitement builds. What will the view from the next level be, and the level after that? The boxes and the collections displayed in them are closed at night. However, the ambitious restaurant on level nine and the escalator-connected walkways and viewing platforms are not. Those outside benefit too. During the day the glass walls are almost invisible. But when the inside is lit up at night, the facade becomes a glowing checkerboard. So far so terrific. What about what's in the boxes?

Some 470,000 objects, the holdings of several former museums and collectors' benefactions, belong to the MAS. Most of it is kept in storage. The museum makes a feature of this; the first visitors' gallery is "Visible Store". The depot contains about 180,000 items. (The rest is kept in facilities elsewhere.) There are rows of pull-out racks for flat works; a central display celebrates early donors; vitrines show examples of gifts that range from fossils to finely engraved caskets. Carl Depauw, the director, calls this the museum's "beating heart." He hopes visitors will come to appreciate that "if you don't take care of objects, who is going to tell us stories about the past?" Indeed it is stories, past and present, that bind together the thousands of objects displayed on the floors above. Their main themes are the "Metropolis", "Power", "Life and Death", and Antwerp's long history as a major international port.

The boxes were inspired by the district's enormous warehouses. Each measures 36 metres by 24 metres (about 118 by 78 feet). Sven Grooten of B-Architecten has demonstrated verve and imagination in using these spaces. He varies colour schemes, spatial configurations and materials. Vivid red dominates in "Power"; the "Life and Death" gallery is entered via a pitch-black maze. "World Port", which tells the tale of Antwerp from the Middle Ages on, is a *coup de theatre*. A central table, 82.4 metres long, supports a flotilla of model ships. There are Chinese junks, Dutch clippers, early steamers and passenger liners.

Projected on the wall behind are lively scenes of the working port today. The gallery perimeter is lined with vitrines showing related objects, such as ships' logs. One floor is devoted to Antwerp's most recent acquisition: Paul and Dora Janssen-Arts's exceptional collection of pre-Columbian objects, which includes jades, terracottas, gold ornaments and textiles. Here the mood is elegant simplicity, with the objects clearly displayed in glass cases.

The museum is also the linchpin of a project to regenerate Antwerp's desolate old port. The ground-floor cafe opened last year and quickly became trendy. It faces a piazza paved with a skull mosaic designed by Luc Tuymans, an international art star and local resident. Nearby, the ground floor of what used to be the Missions to Seamen building is now a restaurant with the curiously apt name of "Marcel". Visiting the MAS is indeed something of a Proustian adventure.

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Sai Baba

Sathya Sai Baba (Satyanarayana Raju), one of India's most controversial gurus, died on April 24th, aged 85



WITH a mere circling wave of His Hand, Sai Baba could make objects materialise out of the air. Gold rings, amulets and necklaces; blocks of sugar candy; images of Shiva made of topaz and sapphire; bottles of tonic and packets of blue pills; rosaries, silver vessels and even medallions inscribed with the name of the recipient, the day and date. He could produce *vibhuti* too, holy Ash that poured from under His fingernails. On average a pound a day flowed from Him as He gave *darshan*, allowing His followers a sight of God as He moved among them, a tiny ochre-robed figure with an immense black afro, or halo, of hair. The Ash might be salty or sweet, blackish or white. Smeared on the body, it forgave sins; taken in water, it helped digestive complaints.

Sceptics were always trying to show how it was done, saying that the Ash was a pellet crushed between His fingers, or that the gold and silver ellipsoidal lingams (the Form of the Formless) that He coughed up at certain festivals were in fact hidden in His handkerchief. The BBC made a documentary, and slow-motion videos were all over YouTube. Sai Baba laughed at their efforts. His miracles were as trivial, in comparison with His Reality, as a mosquito to an elephant. But at least 6m people, probably closer to 100m, in 126 countries of the world, accepted them as tokens of the Divinity He personified. And He was defended by figures no less than Manmohan Singh, prime minister of India, and Sonia Gandhi, leader of the Congress party, who journeyed to pay their respects before his state funeral.

Besides, he said, all the enquiries and science in the world could not begin to explain the other things that He, as an avatar of God, could will to happen. He could raise people from the dead, even when ants were already crawling over them. He could hold back the rains. He could leave His own body, letting it slump stiff and lifeless in His chair for five minutes while He travelled to the Kashmir Front or the seashore at Mumbai. Sufferers from duodenal ulcers would find Him operating on them, materialising the instruments from thin air. He could change water into petrol or diesel on which cars ran for many miles.

A number of more straightforward good works could also be attributed to Him. At remote Puttaparthi in Andhra Pradesh, His birthplace and the site since 1948 of His ashram, He established an airport, two sports stadiums, a free super-speciality hospital and an institute of higher learning rated A++ by the National Assessment and Accreditation Council. He set up free primary and secondary schools all over India, had another free hospital built at Bangalore, and paid for drinking water to be piped from the Krishna river to Chennai and from the Godavari river to upland Andhra Pradesh. Perhaps 2m people benefited. This helped to muffle, though never to quiet entirely, controversies about His $5 billion trust fund and claims of sexual abuse of His boy disciples.

The cobra and the scorpion

But then there had always been people who had refused to believe in His Godhead-from His father, who in the beginning beat Him with a stick and made a village healer lacerate His scalp and rub it with garlic and lime juice to cure His madness, to the rationalist who sued Him in 1986 under the Gold Control Act for bringing so many gold articles out of the air. (The case was dismissed.) They ignored the obvious signs of His divinity, such as the cobra that had cradled Him at birth, or His ability as a schoolboy to bring forth peppermints out of an empty bag. He mostly hid His Godhead in those years, but found it frustrating, and was glad at 14 to be able to reveal (after a scorpion sting had put Him into a trance) that His previous body had been that of a 19th-century saint called Shirdi Sai Baba, whose statue, in marble, He placed beside

His own in His Temples, and whose fresh photograph, in several copies, He would often produce out of the sands of the Chitravathi river.

As a boy He demanded to be worshipped on Thursdays; as a man He enforced no particular rites or rituals, save the chanting of Om and the names of God. (He Himself had 108 names, and this was the number of crystals formed by His steps on the shore, and the number of pearls on the garland that was once presented to Him by the sea.) He endorsed no particular religion, though He used the terms of Hinduism, embracing all faiths as valid ways to truth, love and peace. He ignored distinctions of race or caste, and was happy to eat rice from an aluminium plate in the house of an untouchable. If His teachings had any flavour, it came from His background among poor farming folk. The hearts of His devotees were dry, He said, like a village tank before the monsoon; they had to be ploughed by the mind, watered by prayer, sown with seeds of Love.

The devotees who crowded the Puttaparthi ashram, hoping for Blessing or stuffing their letters of petition into His hands, never questioned who He was. He was all the multiple forms of God in human shape. Though His forecast that he would die in 2020 was a little out, that did not dent the belief that He would return in a new body to carry on His work. And Sai Baba, patting them on the back, had always told them they were God also. All they needed was, like Him, to know it.
